

AVERY DENNISON CORPORATION

Form 10-Q

August 09, 2007

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2007.

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number: 1-7685

AVERY DENNISON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

95-1492269

(I.R.S. Employer Identification No.)

**150 North Orange Grove Boulevard
Pasadena, California**

(Address of principal executive offices)

91103

(Zip Code)

Registrant's telephone number, including area code: (626) 304-2000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Number of shares of \$1 par value common stock outstanding as of July 27, 2007: 106,480,795

**AVERY DENNISON CORPORATION
FISCAL SECOND QUARTER 2007 FORM 10-Q QUARTERLY REPORT
TABLE OF CONTENTS**

	Page
<u>PART I. FINANCIAL INFORMATION (UNAUDITED)</u>	
<u>Item 1. Financial Statements:</u>	
<u>Condensed Consolidated Balance Sheet</u> <u>June 30, 2007 and December 30, 2006</u>	3
<u>Consolidated Statement of Income</u> <u>Three and Six Months Ended June 30, 2007 and July 1, 2006</u>	4
<u>Condensed Consolidated Statement of Cash Flows</u> <u>Six Months Ended June 30, 2007 and July 1, 2006</u>	5
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
<u>Definition of Terms</u>	
<u>Overview and Outlook</u>	
<u>Analysis of Results of Operations for the Second Quarter</u>	
<u>Results of Operations by Segment for the Second Quarter</u>	
<u>Analysis of Results of Operations for the Six Months Year-to-Date</u>	
<u>Results of Operations by Segment for the Six Months Year-to-Date</u>	
<u>Financial Condition</u>	
<u>Uses and Limitations of Non-GAAP Measures</u>	
<u>Recent Accounting Requirements</u>	
<u>Safe Harbor Statement</u>	
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	36
<u>Item 4. Controls and Procedures</u>	36
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	38
<u>Item 1A. Risk Factors</u>	40
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	44
<u>Item 3. Defaults Upon Senior Securities</u>	44
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	45
<u>Item 5. Other Information</u>	45
<u>Item 6. Exhibits</u>	45
<u>Signatures</u>	46
<u>Exhibits</u>	
<u>EXHIBIT 10.2</u>	
<u>EXHIBIT 12</u>	
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	
<u>EXHIBIT 32.2</u>	

Table of Contents

Avery Dennison Corporation

PART 1. FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****CONDENSED CONSOLIDATED BALANCE SHEET***(Unaudited)*

(Dollars in millions)	June 30, 2007	December 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	\$ 76.6	\$ 58.5
Trade accounts receivable, less allowances of \$66.4 and \$58.9 for 2007 and 2006, respectively	1,151.1	910.2
Inventories, net	640.6	471.8
Deferred taxes and other current assets	269.8	214.9
Total current assets	2,138.1	1,655.4
Property, plant and equipment	3,082.3	2,775.6
Accumulated depreciation	(1,504.0)	(1,466.2)
Property, plant and equipment, net	1,578.3	1,309.4
Goodwill	1,567.6	715.9
Other intangibles resulting from business acquisitions, net	352.0	95.5
Other assets	527.6	517.4
	\$ 6,163.6	\$ 4,293.6
Liabilities and Shareholders' Equity		
Current liabilities:		
Short-term and current portion of long-term debt	\$ 1,894.3	\$ 466.4
Accounts payable	708.2	630.1
Other current liabilities	615.6	602.3
Total current liabilities	3,218.1	1,698.8
Long-term debt	506.7	501.6
Non-current deferred and payable income taxes and other long-term liabilities	615.5	412.7
Commitments and contingencies (see Note 16)		
Shareholders' equity:		
Common stock, \$1 par value, authorized 400,000,000 shares at June 30, 2007 and December 30, 2006; issued 124,126,624 shares at June 30, 2007 and December 30, 2006; outstanding 98,184,414 shares and 98,313,102 shares at June 30, 2007 and December 30, 2006, respectively	124.1	124.1
Capital in excess of par value	900.9	881.5
Retained earnings	2,222.5	2,139.9
Cost of unallocated ESOP shares	(5.7)	(5.7)

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

Employee stock benefit trusts, 8,266,381 shares and 8,896,474 shares at June 30, 2007 and December 30, 2006, respectively	(547.5)	(602.5)
Treasury stock at cost, 17,645,829 shares and 16,887,048 shares at June 30, 2007 and December 30, 2006, respectively	(858.2)	(806.7)
Accumulated other comprehensive loss	(12.8)	(50.1)
Total shareholders' equity	1,823.3	1,680.5
	\$ 6,163.6	\$ 4,293.6

See Notes to Unaudited Condensed Consolidated Financial Statements

3

Table of Contents

Avery Dennison Corporation

CONSOLIDATED STATEMENT OF INCOME
(Unaudited)

(In millions, except per share amounts)	Three Months Ended		Six Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Net sales	\$ 1,523.5	\$ 1,409.7	\$ 2,913.4	\$ 2,746.9
Cost of products sold	1,113.7	1,016.7	2,139.2	1,998.7
Gross profit	409.8	393.0	774.2	748.2
Marketing, general and administrative expense	270.8	251.3	519.1	496.1
Interest expense	20.1	13.6	35.2	28.1
Other expense, net	7.5	4.0	9.6	11.6
Income from continuing operations before taxes	111.4	124.1	210.3	212.4
Taxes on income	25.6	27.7	45.3	47.1
Income from continuing operations	85.8	96.4	165.0	165.3
Income from discontinued operations, net of tax (including gain on disposal of \$1.3 and tax benefit of \$15.4 in 2006)		15.6		15.4
Net income	\$ 85.8	\$ 112.0	\$ 165.0	\$ 180.7
Per share amounts:				
Net income per common share:				
Continuing operations	\$.88	\$.96	\$ 1.68	\$ 1.66
Discontinued operations		.16		.15
Net income per common share	\$.88	\$ 1.12	\$ 1.68	\$ 1.81
Net income per common share, assuming dilution:				
Continuing operations	\$.87	\$.96	\$ 1.67	\$ 1.65
Discontinued operations		.16		.15
Net income per common share, assuming dilution	\$.87	\$ 1.12	\$ 1.67	\$ 1.80
Dividends	\$.40	\$.39	\$.80	\$.78
Average shares outstanding:				
Common shares	98.0	100.0	98.0	99.9
Common shares, assuming dilution	98.7	100.4	98.8	100.3
Common shares outstanding at period end	98.2	100.1	98.2	100.1

Table of Contents

Avery Dennison Corporation

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

(In millions)	Six Months Ended	
	June 30, 2007	July 1, 2006
Operating Activities		
Net income	\$ 165.0	\$ 180.7
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	79.7	77.9
Amortization	21.1	21.3
Deferred taxes	3.4	3.7
Asset impairment and net loss (gain) on sale and disposal of assets	13.1	(6.1)
Stock-based compensation	10.3	12.1
Other non-cash items, net	(9.9)	(5.4)
Changes in assets and liabilities, net of the effect of business acquisitions and divestitures	(151.8)	(151.2)
Net cash provided by operating activities	130.9	133.0
Investing Activities		
Purchase of property, plant and equipment	(94.7)	(80.5)
Purchase of software and other deferred charges	(29.0)	(15.7)
Payments for acquisitions	(1,284.1)	
Proceeds from sale of assets	1.7	.9
Proceeds from sale of businesses and investments		29.3
Other	.7	(.8)
Net cash used in investing activities	(1,405.4)	(66.8)
Financing Activities		
Net increase (decrease) in borrowings (maturities of 90 days or less)	1,423.9	(55.7)
Payments of debt (maturities longer than 90 days)	(11.7)	(1.4)
Dividends paid	(85.4)	(85.7)
Purchase of treasury stock	(63.2)	
Proceeds from exercise of stock options, net	30.5	18.6
Other	(2.1)	8.0
Net cash provided by (used in) financing activities	1,292.0	(116.2)
Effect of foreign currency translation on cash balances	.6	.6
Increase (decrease) in cash and cash equivalents	18.1	(49.4)
Cash and cash equivalents, beginning of period	58.5	98.5

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

Cash and cash equivalents, end of period	\$ 76.6	\$ 49.1
--	---------	---------

See Notes to Unaudited Condensed Consolidated Financial Statements

5

Table of Contents

Avery Dennison Corporation

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**Note 1. General**

The accompanying unaudited condensed consolidated financial statements include normal recurring adjustments necessary for a fair presentation of Avery Dennison Corporation's (the Company) interim results. In management's opinion, the unaudited condensed consolidated financial statements and notes in this Form 10-Q are presented as permitted by Regulation S-X. The unaudited condensed consolidated financial statements do not contain certain information included in the Company's 2006 annual financial statements and notes. This Form 10-Q should be read in conjunction with the Company's consolidated financial statements and notes included in the Company's 2006 Annual Report on Form 10-K.

The second quarters of 2007 and 2006 consisted of thirteen-week periods ending June 30, 2007 and July 1, 2006, respectively. The interim results of operations are not necessarily indicative of future financial results.

Note 2. Acquisitions

On June 15, 2007, the Company completed the acquisition of Paxar Corporation (Paxar), a global leader in retail tag, ticketing, and branding systems. In accordance with the terms of the acquisition agreement, each outstanding share of Paxar common stock, par value \$0.10 (other than shares owned by the Company and its subsidiaries) was converted into the right to receive \$30.50 in cash. At June 15, 2007, outstanding options to purchase Paxar Common Stock, shares of Paxar restricted stock and Paxar performance share awards were converted into weight-adjusted options to purchase the Company's common stock, shares of the Company's restricted stock and, at the Company's election, shares of the Company's restricted stock or the Company's restricted stock units, respectively. The occurrence of certain circumstances resulted in the accelerated vesting of certain of these equity awards.

The Paxar operations are included in the Company's Retail Information Services segment. The combination of the Paxar business into the Retail Information Services segment increases the Company's presence in the expanding and fragmented retail information and brand identification market, combines complementary strengths and broadens the range of the Company's product and service capabilities, improves the Company's ability to meet customer demands for product innovation and improved quality of service, and facilitates expansion into new product and geographic segments. The integration of the acquisition into the Company's operations is also expected to result in significant cost synergies.

The total purchase price for this transaction was approximately \$1.33 billion for the outstanding shares of Paxar, including transaction costs of approximately \$14 million. Funds used to complete the acquisition were derived from commercial paper borrowings, supported by a bridge revolving credit facility (see Note 7, Debt). The Company assumed liabilities of approximately \$370 million, including accounts payable and other current and long-term liabilities. The Company included the operating results of Paxar in its unaudited Consolidated Statement of Income for the period from June 15, 2007 to June 30, 2007.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations, the preliminary balance sheet allocation of the purchase price as of June 30, 2007 has been made and recorded in the unaudited Condensed Consolidated Financial Statements. The preliminary allocation of the purchase price was primarily based on preliminary third-party valuations of the acquired assets; however, ongoing assessments are expected to impact the allocation of the purchase price.

The following table summarizes the preliminary estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition.

(In millions)	June 15, 2007
Current assets (including cash and cash equivalents of approximately \$47 million)	\$ 368.0
Property, plant, and equipment	253.3
Other assets	2.6
Intangible assets	260.7
Goodwill	840.3

Total assets acquired	\$ 1,724.9
Current liabilities	192.4
Other long-term liabilities	177.9
Other equity	23.2
Total liabilities and other equity	\$ 393.5
Net assets acquired	\$ 1,331.4

6

Table of Contents

Avery Dennison Corporation

The excess of the cost-basis over the fair value of the net tangible assets acquired is currently estimated to be approximately \$1.1 billion, including goodwill of approximately \$840 million and identified intangible assets of approximately \$261 million, which includes amortizable and non-amortizable intangible assets. Identifiable intangible assets consist of customer relationships, trade name and trademarks, patents and other acquired technology and other intangibles. The goodwill from this acquisition is not expected to be deductible for U.S. tax purposes. Refer also to Note 6, Goodwill and Other Intangibles Resulting from Business Acquisitions. There were no in-progress research and development assets acquired as a result of the acquisition.

Included in the assumed current liabilities were accrued restructuring costs related to Paxar's pre-acquisition restructuring program. At June 30, 2007, \$7 million remained accrued in connection with this program.

As a result of the Paxar acquisition, the Company identified certain costs totaling approximately \$4 million related to exit activities and integration actions. Approximately \$2 million of these costs were related to severance costs for involuntary terminations of approximately 25 employees of Paxar, to be paid through 2008. Also included are lease costs (approximately \$1 million), which are expected to be completed through 2010, and other related costs. At June 30, 2007, all of the \$4 million remained accrued. Of the total positions impacted under these actions, approximately 20 employees remain with the Company as of June 30, 2007. Additional liabilities for exit activities and integration costs are being determined and are expected to be recorded in connection with future purchase price allocations.

In connection with this acquisition, certain change-in-control provisions provided that approximately \$27 million was to be paid to certain key executives of Paxar. This amount includes severance, bonuses, accelerated vesting of stock options, performance share awards, restricted stock, and other items. At June 30, 2007, all of the \$27 million remained accrued in Other current liabilities.

Included in the assumed long-term liabilities was a postretirement benefit obligation totaling approximately \$11 million for certain retired executives of Paxar. The Company expects to incur an additional \$.4 million of net periodic cost for the remainder of 2007.

Other equity includes the total amount related to converted Paxar stock options and performance share awards of approximately \$22 million. This total is net of amounts related to converted unvested stock options and performance share awards (approximately \$5 million), which will be recognized in the Company's operating results over the remaining vesting periods for these equity awards. Refer to Note 10, Stock-based Compensation, for further details. Refer to Note 13, Taxes Based on Income, for information on the tax-related impact of the acquisition.

The following table represents the unaudited pro forma results of operations for the Company as though the acquisition of Paxar had occurred at the beginning of 2006. The pro forma results include estimated interest expense associated with commercial paper borrowings to fund the acquisition; amortization of intangible assets that would have been acquired; adjustment to income tax provision using the worldwide combined effective tax rates of both the Company and Paxar; elimination of intercompany sales and profit in inventory; fair value adjustments to inventory; and additional depreciation resulting from fair value amounts allocated to real and personal property over the estimated useful lives. The pro forma results of operations have been prepared based on the preliminary allocation of the purchase price and are expected to be adjusted as a result of the finalization of the purchase price allocation. This pro forma information is for comparison purposes only, and is not necessarily indicative of the results that would have occurred had the acquisition been completed at the beginning of 2006, nor is it necessarily indicative of future results.

(In millions, except per share amounts)	Three Months Ended		Six Months Ended	
	June 30, 2007⁽¹⁾	July 1, 2006⁽²⁾	June 30, 2007⁽³⁾	July 1, 2006⁽⁴⁾
Net sales	\$ 1,726.8	\$ 1,639.5	\$ 3,327.9	\$ 3,173.0
Net income from continuing operations	77.0	90.7	139.8	143.5

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

Net income per common share from continuing operations	.79	.91	1.43	1.44
Net income per common share from continuing operations, assuming dilution	.78	.90	1.41	1.43

(1) The pro forma results of operations for the second quarter of 2007 include the Company's restructuring costs and other charges discussed in Note 17, Segment Information.

(2) The pro forma results of operations for the second quarter of 2006 include the impact of Paxar's restructuring costs and other charges of \$1.6, as well as the Company's restructuring costs and other charges discussed in Note 17, Segment Information.

(3) The pro forma results of operations for the first six months of 2007 include the impact of Paxar's

restructuring costs and other charges of \$1.8 and merger-related costs of \$1.5, as well as the Company's restructuring costs and other charges discussed in Note 17, Segment Information.

- (4) The pro forma results of operations for the first six months of 2006 include the impact of Paxar's restructuring costs and other charges of \$4.6, as well as the Company's restructuring costs and other charges discussed in Note 17, Segment Information.

Note 3. Discontinued Operations

In 2006, the Company completed the sale of its raised reflective pavement markers business, which was announced in December 2005.

Table of Contents

Avery Dennison Corporation

The results for this business were accounted for as discontinued operations in the consolidated financial statements for the years presented herein. The divestiture resulted in a tax benefit (\$15.4 million) due to capital losses arising from the sale of the business and a gain on sale (\$1.3 million) reported in the second quarter of 2006. This business was previously included in the Pressure-sensitive Materials segment.

Summarized, combined statement of income for discontinued operations:

(In millions)	Three Months Ended July 1, 2006	Six Months Ended July 1, 2006
Net sales	\$ 3.3	\$ 7.0
Loss before taxes	(.7)	(1.0)
Taxes on income	.4	.3
Loss from operations, net of tax	(1.1)	(1.3)
Gain on sale of discontinued operations	1.3	1.3
Tax benefit from sale	(15.4)	(15.4)
Income from discontinued operations, net of tax	\$ 15.6	\$ 15.4

Note 4. Accounts Receivable

The Company recorded expenses related to the allowances for trade accounts receivable of \$4.2 million and \$17.4 million for the six months ended June 30, 2007 and July 1, 2006, respectively. The Company records these allowances based on estimates related to the following factors:

Customer specific allowances

Amounts based upon an aging schedule

An estimated amount, based on the Company's historical experience

Note 5. Inventories

Inventories consisted of:

(In millions)	June 30, 2007	December 30, 2006
Raw materials	\$ 234.8	\$ 157.6
Work-in-progress	143.8	118.4
Finished goods	287.6	220.9
Inventories at lower of FIFO cost or market (approximates replacement cost)	666.2	496.9
Less LIFO adjustment	(25.6)	(25.1)
Inventory, net (on blended FIFO and LIFO basis)	\$ 640.6	\$ 471.8

Note 6. Goodwill and Other Intangibles Resulting from Business Acquisitions

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

Changes in the net carrying amount of goodwill from continuing operations for the periods shown, by reportable segment, are as follows:

(In millions)	Pressure- sensitive Materials	Retail Information Services	Office and Consumer Products	Other specialty converting businesses	Total
Balance as of December 31, 2005	\$ 313.6	\$ 201.3	\$ 157.9	\$.3	\$ 673.1
Transfer of business ⁽¹⁾		(3.1)		3.1	
Goodwill acquired during the period				10.4	10.4
Acquisition adjustments ⁽²⁾		.3			.3
Translation adjustments	18.8	2.0	11.2	.1	32.1
Balance as of December 30, 2006	332.4	200.5	169.1	13.9	715.9
Goodwill acquired during the period		840.3			840.3
Acquisition adjustments ⁽³⁾		(.5)			(.5)
Translation adjustments	8.4	.6	2.9		11.9
Balance as of June 30, 2007	\$ 340.8	\$ 1,040.9	\$ 172.0	\$ 13.9	\$ 1,567.6

Table of Contents

Avery Dennison Corporation

- (1) Transfer of business refers to the transfer of the business media division from Retail Information Services to other specialty converting businesses to align with a change in the Company's internal reporting structure.
- (2) Acquisition adjustments in 2006 consisted of the purchase price allocation of a small acquisition in 2005.
- (3) Acquisition adjustments in 2007 consisted of a tax adjustment associated with RVL Packaging, Inc.

Goodwill and other intangible assets and related useful lives include the preliminary allocation of the purchase price of Paxar, based on preliminary third-party valuations of the acquired assets; as such, the balances may change as a result of the finalization of the purchase price allocation. Refer to Note 2, Acquisitions, for further information. In connection with the Paxar acquisition, the Company acquired approximately \$30 million of intangible assets, consisting of trade names and trademarks, which are not subject to amortization because they have an indefinite useful life. These intangible assets were not included in the table below.

The following table sets forth the Company's preliminary estimates of other intangible assets resulting from business acquisitions at June 30, 2007 and December 30, 2006, which continue to be amortized:

June 30, 2007			December 30, 2006		
Gross		Net	Gross		Net
Carrying	Accumulated	Carrying	Carrying	Accumulated	Carrying

(In millions)	Amount	Amortization	Amount	Amount	Amortization	Amount
Amortizable other intangible assets:						
Customer relationships	\$ 271.3	\$ 28.4	\$ 242.9	\$ 93.0	\$ 25.1	\$ 67.9
Trade names and trademarks	70.5	36.2	34.3	43.2	33.6	9.6
Patented and other acquired technology	52.4	11.8	40.6	28.3	11.0	17.3
Other intangibles	8.4	4.2	4.2	4.8	4.1	.7
Total	\$ 402.6	\$ 80.6	\$ 322.0	\$ 169.3	\$ 73.8	\$ 95.5

Amortization expense on other intangible assets resulting from business acquisitions was \$3 million and \$5.5 million for the three and six months ended June 30, 2007, respectively, and \$2.8 million and \$5.4 million for the three and six months ended July 1, 2006, respectively. Based on current information, including the preliminary assessment for Paxar, estimated amortization expense for other intangible assets resulting from business acquisitions for this fiscal year and each of the next four fiscal years is expected to be approximately \$21 million, \$30 million, \$29 million, \$29 million and \$29 million, respectively.

The weighted-average amortization periods from the date of acquisition for amortizable intangible assets resulting from business acquisitions are fifteen years for customer relationships, thirteen years for trade names and trademarks, thirteen years for patented and other acquired technology, ten years for other intangibles and fourteen years in total. As of June 30, 2007, the weighted-average remaining useful life of acquired amortizable intangible assets are twelve years for customer relationships, nine years for trade names and trademarks, nine years for patented and other acquired technology, eight years for other intangibles and eleven years in total.

Note 7. Debt

On June 13, 2007, the Company entered into a bridge revolving credit facility (Credit Facility) with five domestic and foreign banks for a total commitment of \$1.35 billion, expiring June 11, 2008, for terms which are generally similar to existing credit facilities. Financing available under this agreement is permitted to be used for working capital, commercial paper back-up and other general corporate purposes, including acquisitions.

The Company used the Credit Facility to support commercial paper borrowings totaling approximately \$1.3 billion to fund the Paxar acquisition, discussed in detail in Note 2, Acquisitions. Such commercial paper borrowings are included in Short-term and current portion of long-term debt in the unaudited Condensed Consolidated Balance Sheet. The Credit Facility is subject to customary financial covenants, including a leverage ratio and an interest coverage ratio, for which the Company is in compliance.

In connection with the Paxar acquisition, the Company has assumed additional stand-by letters of credit of \$7.3 million outstanding at June 30, 2007.

Note 8. Pension and Other Postretirement Benefits

The following table sets forth the components of net periodic benefit cost for the periods shown:

Table of Contents

Avery Dennison Corporation

(In millions)	Pension Benefits							
	Three Months Ended				Six Months Ended			
	June 30, 2007		July 1, 2006		June 30, 2007		July 1, 2006	
	U.S.	Int 1	U.S.	Int 1	U.S.	Int 1	U.S.	Int 1
Components of net periodic benefit cost:								
Service cost	\$ 3.9	\$ 3.3	\$ 4.7	\$ 3.2	\$ 9.3	\$ 6.6	\$ 9.6	\$ 6.4
Interest cost	8.7	6.0	7.7	4.7	16.7	11.8	14.9	9.3
Expected return on plan assets	(12.3)	(6.0)	(11.7)	(4.8)	(24.5)	(11.9)	(23.4)	(9.5)
Recognized net actuarial loss	2.8	1.9	2.1	1.5	4.7	3.9	4.0	3.1
Amortization of prior service cost	.5	.1	.4	.2	1.0	.3	.9	.3
Amortization of obligation or asset		(.2)		(.3)		(.5)		(.6)
Recognized gain on curtailment and settlement of an obligation ⁽¹⁾				(1.6)				(1.6)
Net periodic benefit cost	\$ 3.6	\$ 5.1	\$ 3.2	\$ 2.9	\$ 7.2	\$ 10.2	\$ 6.0	\$ 7.4

(In millions)	Postretirement Health Benefits			
	Three Months Ended		Six Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
	U.S.	U.S.	U.S.	U.S.
Components of net periodic benefit cost:				
Service cost	\$.2	\$.2	\$.5	\$.5
Interest cost	.5	.3	.9	.8
Recognized net actuarial loss	.3	.3	.7	.7
Amortization of prior service cost	(.4)	(.4)	(.9)	(.9)
Net periodic benefit cost	\$.6	\$.4	\$ 1.2	\$ 1.1

⁽¹⁾ Recognized gain in 2006 related to the divestiture of

the Company's
filing business
in Europe.

The Company contributed \$1.2 million and \$26.3 million to its U.S. pension plans during the six months ended June 30, 2007 and July 1, 2006, respectively. The Company expects to contribute an additional \$1.9 million to its U.S. pension plans for the remainder of 2007. Additionally, the Company contributed \$3 million and \$1.7 million to its postretirement health benefit plans during the six months ended June 30, 2007 and July 1, 2006, respectively. For the remainder of 2007, the Company expects to contribute an additional \$3 million to its postretirement health benefit plans.

The Company contributed \$9.8 million and \$3.9 million to its international pension plans during the six months ended June 30, 2007 and July 1, 2006, respectively. For the remainder of 2007, the Company expects to contribute an additional \$2.8 million to its international pension plans.

Note 9. Research and Development

Research and development expense for the three and six months ended June 30, 2007 was \$23.6 million and \$45.8 million, respectively. For the three and six months ended July 1, 2006, research and development expense was \$21.9 million and \$43.6 million, respectively.

Note 10. Stock-Based Compensation

Net income included pretax stock-based compensation expense related to stock options, performance share awards, restricted stock units (RSUs) and restricted stock of \$10.3 million and \$12.1 million for the six months ended June 30, 2007 and July 1, 2006, respectively. Included in this expense are Paxar converted stock options and performance share awards, totaling approximately \$.2 million. The total stock-based compensation expense was included in Marketing, general and administrative expense and was recorded in corporate expense and the Company's operating segments, as appropriate.

As of June 30, 2007, the Company has approximately \$43 million of unrecognized compensation cost related to unvested stock options, performance share awards, RSUs and restricted stock under the Company's plans. Included in this unrecognized compensation cost are Paxar converted stock options and performance share awards, totaling approximately \$5 million. The total unrecognized compensation cost is expected to be recognized over the remaining weighted-average requisite service period of approximately 3 years for stock options, 2 years for RSUs and 4 years for restricted stock.

Paxar Acquisition

In connection with the Paxar acquisition, the Company converted Paxar's stock options based on the acquisition price of \$30.50 per share divided by the Company's twenty-day average stock price prior to the acquisition date, which was \$64.82. The total number of stock options resulting from this conversion was approximately 700,000.

Table of Contents

Avery Dennison Corporation

In accordance with SFAS No. 123(R), Share-Based Payment, the total equity compensation recorded in Capital in excess of par value in the Shareholders' equity section of the unaudited Condensed Consolidated Balance Sheet was approximately \$22 million for Paxar's converted stock options. This amount was reduced by approximately \$2 million related to unvested stock options. The compensation expense for these unvested stock options is based on the remaining vesting period of approximately 2 years.

The Company's stock-based compensation expense associated with Paxar converted stock options was based on the estimated fair value as of June 15, 2007, using the Black-Scholes option-pricing model, amortized on a straight-line basis over the remaining requisite service period. This model requires input assumptions for the Company's expected dividend yield, expected volatility, risk-free interest rate and the expected life of the options.

Expected dividend yield and *expected volatility* were based on the Company's assumptions used at fiscal year end December 30, 2006.

Risk-free rate was based on the average of the weekly T-Bond rate for the period closest to the expected term of the 52-week period prior to June 15, 2007.

Expected term was determined based on the average remaining term and average vesting as of June 15, 2007.

Forfeiture rate assumption of 4.44% was based on the weighted average of the Company's and Paxar's forfeiture rate assumptions at fiscal year end 2006, and remaining requisite service period.

Additionally, the Company converted Paxar's performance share awards into approximately 80,000 shares of the Company's common stock, based on the acquisition price of \$30.50 per share divided by the Company's twenty-day average stock price prior to the acquisition date, which was \$64.82. The total equity compensation (approximately \$5 million) for vested and unvested performance share awards, recorded in Capital in excess of par value in the Shareholders' equity section of the unaudited Condensed Consolidated Balance Sheet was calculated using the Company's ending stock price at June 15, 2007 of \$66.69. This amount was reduced by approximately \$3 million related to unvested performance share awards. The compensation expense for these unvested performance share awards is based on the remaining vesting period, which is approximately 2 years.

Note 11. Cost Reduction Actions

Severance charges recorded under the restructuring actions below are included in Other current liabilities in the unaudited Condensed Consolidated Balance Sheet. Severance and related costs represent cash paid or to be paid to employees terminated under these actions. Charges below are included in Other expense, net in the Consolidated Statement of Income.

Second Quarter 2007

In the second quarter of 2007, the Company recorded a pretax charge of \$.9 million related to severance and related costs resulting in the elimination of approximately 20 employees in the Pressure-sensitive Materials and Retail Information Services segments. As of June 30, 2007, all employees impacted by this action have left the Company.

(In millions)	Pressure- sensitive Materials Segment	Retail Information Services Segment	Total
Severance and other employee costs			
Beginning balance	\$.5	\$.4	\$.9
Payments	(.1)	(.4)	(.5)
Balance at June 30, 2007	\$.4	\$	\$.4

First Quarter 2007

In the first quarter of 2007, the Company recorded a pretax charge of \$2.1 million related to severance and related costs resulting in the elimination of approximately 75 positions in the Pressure-sensitive Materials and Office and

Consumer Products segments. At June 30, 2007, approximately 25 employees impacted by this action remain with the Company and are expected to leave during 2007.

Table of Contents

	Avery Dennison Corporation		
(In millions)	Pressure- sensitive Materials Segment	Office and Consumer Products Segment	Total
Severance and other employee costs			
Beginning balance	\$ 1.5	\$.6	\$ 2.1
Payments	(1.1)		(1.1)
Balance at June 30, 2007	\$.4	\$.6	\$ 1.0

2006

During the first three quarters of 2006, the Company continued its cost reduction efforts that were initiated in late 2005, resulting in a further headcount reduction of 410 employees, as well as the impairment of certain assets. In the fourth quarter of 2006, the Company initiated new cost reduction actions, resulting in the elimination of approximately 180 positions and the impairment of certain assets. At June 30, 2007, approximately 110 employees (all related to actions initiated in the fourth quarter of 2006) remain with the Company and are expected to leave in 2007. Pretax charges related to these actions totaled \$29.3 million, including severance and related costs of \$21.1 million, impairment of fixed assets and buildings of \$6.9 million and lease cancellation charges of \$1.3 million. The table below details the accruals and payments related to these actions:

(In millions)	Pressure- sensitive Materials Segment	Retail Information Services Segment	Office and Consumer Products Segment	Other specialty converting businesses	Corporate	Total
Severance and other employee costs						
Accrual at April 1, 2006	\$ 2.6	\$ 2.0	\$.8	\$	\$	\$ 5.4
Accrual at July 1, 2006	2.0	2.0		.7		4.7
Accrual at September 30, 2006	.8	3.6		.1		4.5
Accrual at December 30, 2006	1.9	1.8	1.5	1.3		6.5
Total accruals for 2006 actions	7.3	9.4	2.3	2.1		21.1
2006 payments	(4.5)	(5.3)	(.8)	(1.4)		(12.0)
2007 payments	(1.9)	(2.5)		(.3)		(4.7)
Balance at June 30, 2007	\$.9	\$ 1.6	\$ 1.5	\$.4	\$	\$ 4.4
Asset Impairments						
Buildings	\$.6	\$	\$	\$	\$ 1.3	\$ 1.9

Machinery and equipment	1.7	.5	.7	1.6	.5	5.0
Other						
Lease cancellations		1.3				1.3
	\$ 2.3	\$ 1.8	\$.7	\$ 1.6	\$ 1.8	\$ 8.2

Note 12. Financial Instruments and Foreign Currency

The Company enters into certain foreign exchange hedge contracts to reduce its risk from exchange rate fluctuations associated with receivables, payables, loans and firm commitments denominated in certain foreign currencies that arise primarily as a result of its operations outside the U.S. The Company enters into certain interest rate contracts to help manage its exposure to interest rate fluctuations. The Company also enters into certain natural gas futures contracts to hedge price fluctuations for a portion of its anticipated domestic purchases. The maximum length of time in which the Company hedges its exposure to the variability in future cash flows for forecasted transactions is generally 12 to 24 months.

In June 2007, the Company entered into certain interest rate option contracts to hedge its exposure related to interest rate increases in connection with anticipated long-term debt issuances. Such debt issuances will replace short-term borrowings used to finance the Paxar acquisition, as well as refinance current long-term debt maturities. The Company paid approximately \$9.5 million as an option premium, which will be amortized over the life of the related debt, once issued.

During the three and six months ended June 30, 2007, the amount recognized in earnings related to cash flow hedges that were ineffective was not significant. The aggregate reclassification from other comprehensive income to earnings for settlement or ineffectiveness was a net loss of \$2.4 million and \$5.3 million during the three and six months ended June 30, 2007, respectively. This reclassification was a net gain of \$.3 million and a net loss of \$1 million during the three and six months ended July 1, 2006, respectively. The effect of the settlement of currency hedges included in this reclassification is offset by the currency impact of the underlying hedged activity. A net loss of approximately \$6.7 million is expected to be reclassified from other comprehensive income to earnings within the next 12 months.

Table of Contents

Avery Dennison Corporation

Transactions in foreign currencies (including receivables, payables and loans denominated in currencies other than the functional currency) had a positive impact of \$1.1 million and \$1.2 million on the Company's net income for the three and six months ended June 30, 2007, respectively, decreased net income by \$.7 million during the three months ended July 1, 2006 and increased net income by \$.2 million during the six months ended July 1, 2006. These results do not include the impact of translation of foreign currencies on the Company's financial statements for periods reported or related changes in foreign currency exchange rates.

In the first six months of 2007 and 2006, no translation gains or losses for hyperinflationary economies were recognized in net income. In 2007, the Company had no operations in hyperinflationary economies. In 2006, the only hyperinflationary economy in which the Company operated was in the Dominican Republic, in which the Company uses the U.S. dollar as the functional currency.

Note 13. Taxes Based on Income

The effective tax rate from continuing operations was 23% for the second quarter of 2007, compared to 22.3% for the second quarter of 2006. The effective tax rate for the six months ended June 30, 2007 was 21.5%, compared to 22.2% for the six months ended July 1, 2006. The Company's effective tax rate is lower than the U.S. federal statutory rate of 35%, due to the Company's operations outside the U.S. where the statutory tax rates are generally lower. Additional taxes are not provided for most foreign earnings because the Company currently plans to indefinitely reinvest these amounts. The effective tax rate for the first six months of 2007 includes the net benefit of \$3 million from discrete events, including the release of tax contingencies, partially offset by accruals relating to tax return filings and valuation allowances.

At the beginning of the first quarter of 2007 (December 31, 2006), the Company adopted the provisions of the Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). Upon adoption of FIN 48, the Company recognized a decrease of \$2.9 million in the liability for unrecognized tax benefits, which was accounted for as an increase to the beginning balance of retained earnings. As of the date of adoption, and after the impact of recognizing the decrease in liability noted above, the Company's unrecognized tax benefits totaled \$38.2 million, including \$26.2 million of unrecognized tax benefits which, if recognized, would reduce the annual effective income tax rate. As a result of the Paxar acquisition, there was an increase to unrecognized tax benefits of \$43.8 million which, if recognized, would not impact the annual effective income tax rate. On June 30, 2007, the Company's unrecognized tax benefits totaled \$75.8 million, including \$21.9 million of unrecognized tax benefits which, if recognized, would reduce the annual effective income tax rate. The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits, where applicable, within its global operations in income tax expense. For the first six months of 2007, the Company accrued \$.3 million in potential interest and penalties associated with uncertain tax positions. In conjunction with the adoption of FIN 48, the Company recognized approximately \$2 million of interest and penalties, which is included as a component of the \$38.2 million unrecognized tax benefit noted above. To the extent interest and penalties are not assessed with respect to unrecognized tax benefits, amounts accrued will be reduced and reflected as a reduction of the effective income tax rate.

The amount of income taxes the Company pays is subject to ongoing audits by taxing jurisdictions around the world. The Company's estimate of the potential outcome of any uncertain tax issue is subject to management's assessment of relevant risks, facts, and circumstances existing at that time. The Company believes that it has adequately provided for reasonably foreseeable outcomes related to these matters. However, the Company's future results may include favorable or unfavorable adjustments to its estimated tax liabilities in the period the assessments are made or resolved, which may impact the Company's effective tax rate. With some exceptions, the Company and its subsidiaries are no longer subject to income tax examinations by tax authorities for years prior to 2001.

It is reasonably possible that within the next 12 months, the Company may recognize between \$0 and \$8 million of unrecognized tax benefits, primarily as a result of the expiration of relevant statutes of limitations in multiple non-U.S. jurisdictions.

Note 14. Net Income Per Share

Net income per common share amounts were computed as follows:

Table of Contents

Avery Dennison Corporation

(In millions, except per share amounts)	Three Months Ended		Six Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
(A) Income from continuing operations	\$ 85.8	\$ 96.4	\$ 165.0	\$ 165.3
(B) Income from discontinued operations		15.6		15.4
(C) Net income available to common shareholders	85.8	112.0	165.0	180.7
(D) Weighted-average number of common shares outstanding	98.0	100.0	98.0	99.9
Dilutive shares (additional common shares issuable under employee stock options, RSUs and restricted stock)	.7	.4	.8	.4
(E) Weighted-average number of common shares outstanding, assuming dilution	98.7	100.4	98.8	100.3
Income from continuing operations per common share (A) ÷ (D)	\$.88	\$.96	\$ 1.68	\$ 1.66
Income from discontinued operations per common share (B) ÷ (D)		.16		.15
Net income per common share (C) ÷ (D)	\$.88	\$ 1.12	\$ 1.68	\$ 1.81
Income from continuing operations per common share, assuming dilution (A) ÷ (E)	\$.87	\$.96	\$ 1.67	\$ 1.65
Income from discontinued operations per common share, assuming dilution (B) ÷ (E)		.16		.15
Net income per common share, assuming dilution (C) ÷ (E)	\$.87	\$ 1.12	\$ 1.67	\$ 1.80

Certain employee stock options, RSUs, performance share awards and shares of restricted stock were not included in the computation of net income per common share, assuming dilution, because they would not have had a dilutive effect. Employee stock options, RSUs, performance share awards and shares of restricted stock excluded from the computation totaled 3.0 million and 2.9 million for the three and six months ended June 30, 2007, and 5.6 million for the three and six months ended July 1, 2006.

Note 15. Comprehensive Income

Comprehensive income includes net income, foreign currency translation adjustments, the amortization of net actuarial loss, prior service cost and net transition assets, net of tax, and the gains or losses on the effective portion of cash flow and firm commitment hedges, net of tax, that are currently presented as a component of shareholders' equity. The Company's total comprehensive income was \$102 million and \$202.3 million for the three and six months ended June 30, 2007, and \$121.5 million and \$198.7 million for the three and six months ended July 1, 2006.

The components of accumulated other comprehensive loss (net of tax, except for foreign currency translation) at the end of the following periods were as follows:

(In millions)	June 30, 2007	December 30, 2006
Foreign currency translation adjustment	\$ 182.4	\$ 137.6
Net actuarial loss, prior service cost and net transition assets less amortization	(178.1)	(170.8)
Effect of the change in measurement date		.1
Net loss on derivative instruments designated as cash flow and firm commitment hedges	(17.1)	(17.0)
Total accumulated other comprehensive loss	\$ (12.8)	\$ (50.1)

Cash flow and firm commitment hedging instrument activity in other comprehensive income (loss), net of tax, was as follows:

(In millions)	June 30, 2007
Beginning accumulated derivative loss	\$ (17.0)
Net loss reclassified to earnings	5.3
Net change in the revaluation of hedging transactions	(5.4)
Ending accumulated derivative loss	\$ (17.1)

Note 16. Commitments and Contingencies

Industry Investigations

On June 18, 2007, the Canadian Department of Justice notified the Company that the Competition Law Division of the Canadian Department of Justice had decided to close its criminal investigation (initiated in July 2004) into competitive practices in the label stock industry without further action, as described below.

On November 15, 2006, the Company announced that it had been notified that the European Commission (EC) had closed its investigation (initiated in May 2004) into the Company's competitive activities in the label stock industry with no action, as described below.

On October 19, 2006, the U.S. Department of Justice notified the Company that the U.S. Department of Justice had decided to close its criminal investigation (initiated in April 2003) into competitive practices in the label stock industry without further action, as described below.

Table of Contents

Avery Dennison Corporation

On April 14, 2003, the Company announced that it had been notified that the U.S. Department of Justice (DOJ) had initiated a criminal investigation into competitive practices in the label stock industry. The Company cooperated with the now closed investigation.

On April 15, 2003, the U.S. Department of Justice filed a complaint in the U.S. District Court for the Northern District of Illinois (DOJ Merger Complaint) seeking to enjoin the proposed merger of UPM-Kymmene (UPM) and the Morgan Adhesives (MACTac) division of Bemis Co., Inc. (Bemis). The DOJ Merger Complaint included references not only to the parties to the merger, but also to an unnamed Leading Producer of North American label stock, which is the Company. The DOJ Merger Complaint asserted that UPM and the Leading Producer have already attempted to limit competition between themselves, as reflected in written and oral communications to each other through high level executives regarding explicit anticompetitive understandings, although the extent to which these efforts have succeeded is not entirely clear to the United States at the present time. On July 25, 2003, the United States District Court for the Northern District of Illinois entered an order enjoining the proposed merger. UPM and Bemis thereafter agreed to terminate the merger agreement.

On April 24, 2003, Sentry Business Products, Inc. filed a purported class action in the United States District Court for the Northern District of Illinois against the Company, UPM, Bemis and certain of their subsidiaries seeking treble damages and other relief for alleged unlawful competitive practices, essentially repeating the underlying allegations of the DOJ Merger Complaint. Ten similar complaints were filed in various federal district courts. In November 2003, the cases were transferred to the United States District Court for the Middle District of Pennsylvania and consolidated for pretrial purposes. Plaintiffs filed a consolidated complaint on February 16, 2004, which the Company answered on March 31, 2004. On April 14, 2004, the court separated the proceedings as to class certification and merits discovery, and limited the initial phase of discovery to the issue of the appropriateness of class certification. On January 4, 2006, plaintiffs filed an amended complaint. On March 1, 2007, the court heard oral argument on the issue of the appropriateness of class certification. The Company intends to defend these matters vigorously.

On May 6, 2003, Sekuk Global Enterprises filed a purported stockholder class action in the United States District Court for the Central District of California against the Company and Messrs. Neal, O Bryant and Skovran (then CEO, CFO and Controller, respectively) seeking damages and other relief for alleged disclosure violations pertaining to alleged unlawful competitive practices. Subsequently, another similar action was filed in the same court. On September 24, 2003, the court appointed a lead plaintiff, approved lead and liaison counsel and ordered the two actions consolidated as the In Re Avery Dennison Corporation Securities Litigation. Pursuant to court order and the parties stipulation, plaintiff filed a consolidated complaint in mid-February 2004. The court approved a briefing schedule for defendants motion to dismiss the consolidated complaint, with a contemplated hearing date in June 2004. In January 2004, the parties stipulated to stay the consolidated action, including the proposed briefing schedule, pending the outcome of the government investigation of alleged anticompetitive conduct by the Company. On January 12, 2007, following the DOJ s closing of its investigation, the plaintiffs filed a notice of voluntary dismissal of the case without prejudice. On January 17, 2007, the Court entered an order dismissing the case.

On May 21, 2003, The Harman Press filed in the Superior Court for the County of Los Angeles, California, a purported class action on behalf of indirect purchasers of label stock against the Company, UPM and UPM s subsidiary Raflatac (Raflatac), seeking treble damages and other relief for alleged unlawful competitive practices, essentially repeating the underlying allegations of the DOJ Merger Complaint. Three similar complaints were filed in various California courts. In November 2003, on petition from the parties, the California Judicial Council ordered the cases be coordinated for pretrial purposes. The cases were assigned to a coordination trial judge in the Superior Court for the City and County of San Francisco on March 30, 2004. On January 21, 2005, American International Distribution Corporation filed a purported class action on behalf of indirect purchasers in the Superior Court for Chittenden County, Vermont. Similar actions were filed by Richard Wrobel, on February 16, 2005, in the District Court of Johnson County, Kansas; and by Chad and Terry Muzzey, on February 16, 2005 in the District Court of Scotts Bluff County, Nebraska. On February 17, 2005, Judy Benson filed a purported multi-state class action on behalf of indirect purchasers in the Circuit Court for Cocke County, Tennessee. The Company intends to defend these matters vigorously.

On May 25, 2004, officials from the European Commission (EC), assisted by officials from national competition authorities, launched unannounced inspections of and obtained documents from the Company s pressure-sensitive materials facilities in the Netherlands and Germany. The investigation apparently sought evidence of unlawful anticompetitive activities affecting the European paper and forestry products sector, including the label stock market. The Company cooperated with the now closed investigation.

On July 9, 2004, the Competition Law Division of the Department of Justice of Canada notified the Company that it was seeking information from the Company in connection with a label stock investigation. The Company cooperated with the now closed investigation.

Table of Contents

Avery Dennison Corporation

On May 18, 2005, Ronald E. Dancer filed a purported class action in the United States District Court for the Central District of California against the Company, Mr. Neal, Karyn Rodriguez (VP and Treasurer) and James Bochinski (then VP, Compensation and Benefits), for alleged breaches of fiduciary duty under the Employee Retirement Income Security Act to the Company's Employee Savings Plan and Plan participants. The plaintiff alleges, among other things, that permitting investment in and retention of Company Common Stock under the Plan was imprudent because of alleged anticompetitive activities by the Company, and that failure to disclose such activities to the Plan and participants was unlawful. Plaintiff seeks an order compelling defendants to compensate the Plan for any losses and other relief. The court approved the parties' stipulation to stay the matter pending the outcome of the government investigation of alleged anticompetitive conduct by the Company. The Company intends to defend this matter vigorously.

On August 18, 2005, the Australian Competition and Consumer Commission notified two of the Company's subsidiaries, Avery Dennison Material Pty Limited and Avery Dennison Australia Pty Ltd, that it was seeking information in connection with a label stock investigation. The Company is cooperating with the investigation.

On October 19, 2006, the DOJ notified the Company that the DOJ decided to close its criminal investigation into competitive practices in the label stock industry without further action.

On November 15, 2006, the Company announced that it had been notified that the EC had closed its investigation into the Company's competitive activities in the label stock industry with no action.

On June 18, 2007, the Canadian Department of Justice notified the Company that the Competition Law Division of the Canadian Department of Justice had decided to close its criminal investigation into competitive practices in the label stock industry without further action.

The Board of Directors created an ad hoc committee comprised of independent directors to oversee the foregoing matters.

The Company is unable to predict the effect of these matters at this time, although the effect could be adverse and material.

Environmental

The Company has been designated by the U.S. Environmental Protection Agency (EPA) and/or other responsible state agencies as a potentially responsible party (PRP) at eighteen waste disposal or waste recycling sites, including Paxar sites, which are the subject of separate investigations or proceedings concerning alleged soil and/or groundwater contamination and for which no settlement of the Company's liability has been agreed. The Company is participating with other PRPs at such sites, and anticipates that its share of cleanup costs will be determined pursuant to remedial agreements entered into in the normal course of negotiations with the EPA or other governmental authorities.

The Company has accrued liabilities for these and certain other sites, including sites in which governmental agencies have designated the Company as a PRP, where it is probable that a loss will be incurred and the cost or amount of loss can be reasonably estimated. However, because of the uncertainties associated with environmental assessment and remediation activities, future expense to remediate the currently identified sites and any sites which could be identified in the future for cleanup could be higher than the liability currently accrued.

During the third quarter of 2006, the Company recognized additional liability of \$13 million for estimated environmental remediation costs for a former operating facility, for which \$2 million had been accrued in the second quarter of 2006. The amount accrued represents the lower end of the current estimated range of \$15 million to \$17 million for costs expected to be incurred. Management considered additional information provided by outside consultants in revising its previous estimates of expected costs. This estimate could change depending on various factors such as modification of currently planned remedial actions, changes in the site conditions, a change in the estimated time to complete remediation, changes in laws and regulations affecting remediation requirements and other factors.

Other amounts currently accrued are not significant to the consolidated financial position of the Company and, based upon current information, management believes it is unlikely that the final resolution of these matters will significantly impact the Company's consolidated financial position, results of operations or cash flows.

Product Warranty

The Company provides for an estimate of costs that may be incurred under its basic limited warranty at the time product revenue is recognized. These costs primarily include materials and labor associated with the service or sale of the product. Factors that affect the Company's warranty liability include the number of units installed or sold, historical and anticipated rate of warranty claims on those units, cost per claim to satisfy the Company's warranty obligation and availability of insurance coverage. As these factors are impacted by actual experience and future expectations, the Company assesses the adequacy of its recorded warranty liability and adjusts the amounts as necessary.

Table of Contents

Avery Dennison Corporation

Product warranty liabilities were as follows:

(In millions)	June 30, 2007	December 30, 2006
Balance at beginning of year	\$ 1.9	\$ 2.5
Accruals for warranties issued	.4	.7
Acquired accrued warranty liability ⁽¹⁾	.5	
Payments	(1.1)	(1.3)
Balance at end of period	\$ 2.7	\$ 1.9

(1) Consists of
accrued
warranty
liability of
Paxar

Other

In 2005, the Company contacted relevant authorities in the U.S. and reported on the results of an internal investigation of potential violations of the U.S. Foreign Corrupt Practices Act. The transactions at issue were carried out by a small number of employees of the Company's reflective business in China, and involved, among other things, impermissible payments or attempted impermissible payments. The payments or attempted payments and the contracts associated with them appear to have been relatively minor in amount and of limited duration. Corrective and disciplinary actions have been taken. Sales of the Company's reflective business in China in 2005 were approximately \$7 million. Based on findings to date, no changes to the Company's previously filed financial statements are warranted as a result of these matters. However, the Company believes that fines or other penalties may be incurred. While the Company is unable to predict the financial or operating impact of any such fines or penalties, it believes that its behavior in detecting, investigating, responding to and voluntarily disclosing these matters to authorities should be viewed favorably.

The Company and its subsidiaries are involved in various other lawsuits, claims and inquiries, most of which are routine to the nature of the business. Based upon current information, management believes that the resolution of these other matters will not materially affect the Company's financial position.

The Company participates in international receivable financing programs with several financial institutions whereby advances may be requested from these financial institutions. Such advances are guaranteed by the Company. At June 30, 2007, the Company had guaranteed approximately \$15 million.

As of June 30, 2007, the Company guaranteed up to approximately \$21 million of certain foreign subsidiaries obligations to their suppliers.

On September 9, 2005, the Company completed the lease financing for a commercial facility (the Facility) located in Mentor, Ohio, used primarily for the new headquarters and research center for the Company's roll materials division. The Facility consists generally of land, buildings, equipment and office furnishings. The Company leased the Facility under an operating lease arrangement, which contains a residual value guarantee of \$33.4 million. The Company does not expect the residual value of the Facility to be less than the amount guaranteed.

Note 17. Segment Information

As discussed in Note 2, Acquisitions, the Company completed the acquisition of Paxar during the second quarter. The operating results for Paxar are included in the Retail Information Services segment.

Financial information by reportable segment and other businesses is set forth below:

17

Table of Contents

Avery Dennison Corporation

(In millions)	Three Months Ended		Six Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Net sales to unaffiliated customers:				
Pressure-sensitive Materials	\$ 879.3	\$ 809.5	\$ 1,739.3	\$ 1,596.7
Retail Information Services	219.1	181.4	375.4	335.2
Office and Consumer Products	262.7	265.4	477.1	505.3
Other specialty converting businesses	162.4	153.4	321.6	309.7
Net sales to unaffiliated customers	\$ 1,523.5	\$ 1,409.7	\$ 2,913.4	\$ 2,746.9
Intersegment sales:				
Pressure-sensitive Materials	\$ 41.5	\$ 38.7	\$ 76.6	\$ 77.2
Retail Information Services	.3	1.1	.8	1.8
Office and Consumer Products	.4	.5	.8	1.0
Other specialty converting businesses	5.2	3.6	9.1	6.7
Eliminations	(47.4)	(43.9)	(87.3)	(86.7)
Intersegment sales	\$	\$	\$	\$
Income from continuing operations before taxes:				
Pressure-sensitive Materials	\$ 88.9	\$ 77.4	\$ 170.8	\$ 143.3
Retail Information Services	.6	21.0	7.8	28.6
Office and Consumer Products	42.3	45.3	68.8	81.1
Other specialty converting businesses	6.9	4.6	17.8	10.8
Corporate expense	(7.2)	(10.6)	(19.7)	(23.3)
Interest expense ⁽⁵⁾	(20.1)	(13.6)	(35.2)	(28.1)
Income from continuing operations before taxes	\$ 111.4 ⁽¹⁾	\$ 124.1 ⁽²⁾	\$ 210.3 ⁽³⁾	\$ 212.4 ⁽⁴⁾

(1) Operating income for the second quarter of 2007 includes Other expense, net totaling \$7.5 consisting of integration-related asset impairment charges of \$9.5, restructuring costs of \$.9 and expenses related to

a divestiture of
\$.3, partially offset
by a reversal of
\$(3.2) related to a
patent lawsuit. Of
the total \$7.5, the
Pressure-sensitive
Materials segment
recorded \$(2.7),
the Retail
Information
Services segment
recorded \$9.9
(including \$9.5 of
integration-related
asset impairment)
and the Office and
Consumer
Products segment
recorded \$.3.

Additionally,
operating income
for the Retail
Information
Services segment
for the second
quarter of 2007
included \$8.3 of
integration costs
associated with the
Paxar acquisition.

- (2) Operating income
for the second
quarter of 2006
includes Other
expense, net
totaling \$4
consisting of
restructuring costs
and asset
impairment
charges of \$6.1,
charitable
contribution of \$10
to the Avery
Dennison
Foundation,
partially offset by
gain on sale of

investment of \$(10.5), and gain on curtailment and settlement of a pension obligation of \$(1.6). Of the \$4 total in Other expense, net, the Pressure-sensitive Materials segment recorded \$2.1, the Retail Information Services segment recorded \$2, the Office and Consumer Products segment recorded \$(1.6), the other specialty converting businesses recorded \$.7 and Corporate recorded \$.8.

- (3) Operating income for the first six months of 2007 includes Other expense, net totaling \$9.6 consisting of integration-related asset impairment charges of \$9.5, restructuring costs of \$3 and expenses related to a divestiture of \$.3, partially offset by a reversal of \$(3.2) related to a patent lawsuit. Of the total \$9.6, the Pressure-sensitive Materials segment recorded \$(1.2), the Retail Information Services segment recorded \$9.9

(including \$9.5 of integration-related asset impairment), and the Office and Consumer Products segment recorded \$.9.

Additionally, operating income for the Retail Information Services segment for the first six months of 2007 included \$8.3 of integration costs associated with the Paxar acquisition.

- (4) Operating income for the first six months of 2006 includes Other expense, net totaling \$11.6 consisting of restructuring costs and asset impairment charges of \$13.3, legal accrual related to a patent lawsuit of \$.4 and charitable contribution of \$10 to the Avery Dennison Foundation, partially offset by gain on sale of investment of \$(10.5), and gain on curtailment and settlement of a pension obligation of \$(1.6). Of the total \$11.6 in Other expense, net, the Pressure-sensitive

Materials segment recorded \$6.1, the Retail Information Services segment recorded \$4.3, and the Office and Consumer Products segment recorded \$(.8), the other specialty converting businesses recorded \$.7 and Corporate recorded \$1.3.

- (5) Interest expense during the first three and six months of 2007 included \$3.2 of interest associated with borrowings to fund the Paxar acquisition.

Note 18. Recent Accounting Requirements

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FAS 115 (February 2007). This Statement details the disclosures required for items measured at fair value. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company will adopt this Statement when applicable. The Company is currently evaluating the impact of this Statement on the results of operations and financial position.

Table of Contents

Avery Dennison Corporation

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosure about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company will adopt this Statement when applicable. The Company is currently evaluating the impact of this Statement on the results of operations and financial position.

In September 2006, the FASB issued FSP AUG AIR-1, Accounting for Planned Major Maintenance Activities. This FSP prohibits the use of the accrue-in-advance method of accounting and directs that entities shall apply the same method of accounting for planned major maintenance activities in annual and interim financial reporting periods. The guidance in this FSP is effective for fiscal years beginning after December 15, 2006. The adoption of this guidance has not had a significant impact on the results of operations and financial position.

In July 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which is a change in accounting for income taxes. FIN 48 specifies how tax benefits for uncertain tax positions are to be recognized, measured, and derecognized in financial statements; requires certain disclosures of uncertain tax matters; specifies how reserves for uncertain tax positions should be classified on the balance sheet; and provides transition and interim period guidance, among other provisions. FIN 48 is effective for fiscal years beginning after December 15, 2006 and the Company adopted this Interpretation in 2007. Upon adoption of FIN 48, the Company recognized a decrease of \$2.9 million in the liability for unrecognized tax benefits, which was accounted for as an increase to the beginning balance of retained earnings. See Note 13, Taxes Based on Income, for further discussion.

In March 2006, the consensus of Emerging Issues Task Force Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation), was published. The scope of this Issue includes any tax assessed by a government authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer, and may include, but is not limited to, sales, use, value-added, and some excise taxes. The consensus of this Issue should be applied for interim and annual reporting periods beginning after December 15, 2006. The adoption of this Issue has not had a significant impact on the Company's results of operations, because the Company does not generally recognize taxes collected from customers and remitted to governmental authorities in the Company's results of operations.

Note 19. Subsequent Event

The Company is in the process of amending its revolving credit agreement, increasing commitments from \$525 million to \$1 billion and extending the maturity to August 2012. Commitments are expected to be provided by 12 domestic and foreign banks. Financing available under the agreement will be used as a commercial paper back-up facility and is also available to finance other corporate requirements. Terms under the agreement are expected to be substantially unchanged.

19

Table of Contents

Avery Dennison Corporation

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**ORGANIZATION OF INFORMATION**

Management's Discussion and Analysis provides a narrative concerning our financial performance and condition that should be read in conjunction with the accompanying financial statements. It includes the following sections:

<u>Definition of Terms</u>	<u>20</u>
<u>Overview and Outlook</u>	<u>20</u>
<u>Analysis of Results of Operations for the Second Quarter</u>	<u>23</u>
<u>Results of Operations by Segment for the Second Quarter</u>	<u>25</u>
<u>Analysis of Results of Operations for the Six Months Year-to-Date</u>	<u>27</u>
<u>Results of Operations by Segment for the Six Months Year-to-Date</u>	<u>28</u>
<u>Financial Condition</u>	<u>30</u>
<u>Uses and Limitations of Non-GAAP Measures</u>	<u>35</u>
<u>Recent Accounting Requirements</u>	<u>35</u>
<u>Safe Harbor Statement</u>	<u>36</u>

DEFINITION OF TERMS

Our discussion of financial results includes several non-GAAP measures to provide additional information concerning Avery Dennison Corporation's (the Company's) performance. These non-GAAP financial measures are not in accordance with, nor are they a substitute for, GAAP financial measures. These non-GAAP financial measures are intended to supplement our presentation of our financial results that are prepared in accordance with GAAP. Refer to Use and Limitations of Non-GAAP Measures.

We use the following terms:

Organic sales growth refers to the change in sales excluding the estimated impact of currency translation, acquisitions and divestitures;

Core unit volume refers to a measure of sales performance that excludes the estimated impact of currency translation, acquisitions and divestitures, as well as changes in product mix and pricing;

Segment operating income refers to income before interest and taxes;

Free cash flow refers to cash flow from operations, less payments for capital expenditures, software and other deferred charges; and

Operational working capital refers to trade accounts receivable and inventories, net of accounts payable.

As a result of the sale of our raised reflective pavement marker business during 2006 (discussed below in

Divestitures), the discussions which follow generally reflect summary results from our continuing operations unless otherwise noted. However, the net income and net income per share discussions include the impact of discontinued operations.

OVERVIEW AND OUTLOOK**Overview****Sales**

Our sales from continuing operations in the first three and six months of 2007 increased 8% and 6%, respectively, compared to the same period in 2006, reflecting the factors summarized in the following table.

	Three Months Ended		Six Months Ended	
	June 30,	July 1,	June 30,	July 1,
	2007	2006	2007	2006
Estimated change in sales due to:				

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

Core unit volume	3%	1%	2%	1%
Pricing and product mix	<(1)	1	<(1)	1
Organic sales growth ⁽¹⁾	2%	2%	2%	2%
Foreign currency translation	<4	<(1)	3	(2)
Acquisitions, net of divestitures	<3	(1)	1	(1)
Reported sales growth ⁽¹⁾	8%	(0.1)%	6%	(0.3)%

(1) Totals may not
sum due to
rounding

Table of Contents

Avery Dennison Corporation

Organic sales growth in the first three and six months of 2007 reflected growth in the Pressure-sensitive Materials segment and other specialty converting businesses. Growth in these businesses was driven by expansion of international markets, partially offset by sales decreases in our Pressure-sensitive Materials segment in North America, which reflected slow market conditions for that region. The organic growth in Pressure-sensitive Materials and other specialty converting businesses was partially offset by weaker results for the Retail Information Services and Office and Consumer Products segments.

Net Income

Net income decreased \$16 million, or 9%, in the first six months of 2007 compared to the same period in 2006 due to a tax benefit related to capital losses arising from the sale of discontinued operations.

Positive factors affecting net income included:

Higher net sales

Cost savings from productivity improvement initiatives, including savings from restructuring actions

Lower restructuring charges and asset impairment charges (unrelated to the Paxar Corporation (Paxar) integration) in 2007 compared to 2006

Benefit of a lower effective tax rate on continuing operations

Negative factors affecting net income included:

Impairment of software and integration costs related to the Paxar acquisition

More competitive pricing environment and unfavorable product mix in the roll materials business

Higher raw material and employee-related costs

Higher costs in Retail Information Services due to increased investment in information technology and employee costs in Asia

Transition costs associated with restructuring actions

Acquisitions

We completed the Paxar acquisition on June 15, 2007. The combination of the Paxar business into our Retail Information Services segment increases our presence in the expanding and fragmented retail information and brand identification market, combines complementary strengths and broadens the range of our product and service capabilities, improves our ability to meet customer demands for product innovation and improved quality of service, and facilitates expansion into new product and geographic segments. The integration of the acquisition into our operations is also expected to result in significant cost synergies. Refer to the Outlook section herein for further information.

Results for Paxar's operations during the period from June 15, 2007 to June 30, 2007 included sales of approximately \$37 million and operating loss of approximately \$(.7) million, which includes the impact of preliminary asset valuation (affecting inventory and property, plant and equipment), change-in-control costs, and amortization of intangible assets.

See Note 2, Acquisitions, to the unaudited Condensed Consolidated Financial Statements for further information.

Divestitures

The divestiture of our raised reflective pavement marker business was completed during the second quarter of 2006 and resulted in a 2006 tax benefit due to capital losses arising from the sale of the business and a gain on sale reported in the second quarter of 2006. The results of this business have been accounted for as discontinued operations for the years presented herein. This business was previously included in the Pressure-sensitive Materials segment.

The divestitures of two product lines were completed in the first quarter of 2006. The first product line, which was included in the Office and Consumer Products segment, had sales of approximately \$9 million in the first quarter of 2006, with minimal impact to income from operations. The second product line, which was included in other specialty converting businesses, had sales of approximately \$2 million in the first quarter of 2006, with minimal impact to income from operations.

Cost Reduction Actions

During late 2005 and 2006, we implemented cost reduction actions that have improved our global operating efficiencies that were expected to yield annualized pretax savings of over \$90 million. We estimate that approximately \$50 million of these savings (net of transition costs) were achieved in 2006, while the balance is expected to benefit 2007. We are reinvesting some of the savings in future growth opportunities. We incurred transition costs related to these actions during the first six months of 2007.

Table of Contents

Avery Dennison Corporation

We are undertaking additional restructuring actions in 2007, for which we will incur transition costs throughout the year. The 2007 restructuring actions identified to date are expected to yield annualized savings of approximately \$20 million. Savings from these actions in 2007 are largely offset by transition costs. Incremental savings in 2008 associated with these actions are expected to be approximately \$15 million to \$20 million. See Note 11, *Cost Reduction Actions*, to the unaudited Condensed Consolidated Financial Statements for further detail. Expected synergies resulting from the acquisition of Paxar are discussed in the *Outlook* section below.

Effective Rate of Taxes on Income

The effective tax rate from continuing operations was 21.5% for the first six months of 2007 compared with 22.2% for the same period in 2006, and 17.2% for the full year of 2006. The effective tax rate for the first six months of 2007 includes the net benefit of \$3 million from discrete events, including the release of tax contingencies, partially offset by accruals relating to tax return filings and valuation allowances.

Free Cash Flow

Free cash flow, which is a non-GAAP measure, refers to cash flow from operating activities less spending on property, plant, equipment, software and other deferred charges. We use free cash flow as a measure of funds available for other corporate purposes, such as dividends, debt reduction, acquisitions, and repurchases of common stock. Management believes that this measure provides meaningful supplemental information to our investors to assist them in their financial analysis of the Company. Management believes that it is appropriate to measure cash after spending on property, plant, equipment, software and other deferred charges because such spending is considered integral to maintaining or expanding our underlying business. This measure is not intended to represent the residual cash available for discretionary purposes. Refer to the *Uses and Limitations of Non-GAAP Measures* section for further information regarding limitations of this measure.

(In millions)	Six Months Ended	
	June 30, 2007	July 1, 2006
Net cash provided by operating activities	\$ 130.9	\$ 133.0
Purchase of property, plant and equipment	(94.7)	(80.5)
Purchase of software and other deferred charges	(29.0)	(15.7)
Free cash flow	\$ 7.2	\$ 36.8

See *Analysis of Results of Operations* and *Liquidity* below for more information.

Investigations

On June 18, 2007, we were notified by the Canadian Department of Justice that the Competition Law Division of the Canadian Department of Justice had decided to close its crimination investigation (initiated July 2004) into competitive practices in the label stock industry without further action.

On November 15, 2006, we announced that we had been notified by the European Commission (*EC*) that the EC had closed its investigation (initiated in May 2004) into competitive activities in the label stock industry with no action.

On October 19, 2006, we were notified by the U.S. Department of Justice's Antitrust Division (*DOJ*) that the DOJ had decided to close its criminal investigation (initiated in April 2003) into competitive practices in the label stock industry without further action.

In August 2005, we were notified by the Australian Competition and Consumer Commission that it was seeking information in connection with a label stock investigation. We are cooperating with this investigation.

We are a named defendant in purported class actions in the U.S. seeking treble damages and other relief for alleged unlawful competitive practices, which were filed after the announcement of the DOJ investigation. We are also a named defendant in a purported class action in the U.S. seeking damages and other relief for alleged disclosure and fiduciary duty violations pertaining to alleged unlawful competitive practices.

We have discovered instances of conduct by certain employees in China that potentially violate the U.S. Foreign Corrupt Practices Act. We have reported that conduct to authorities in the U.S. and we believe it is possible that fines or other penalties may be incurred.

Table of Contents

Avery Dennison Corporation

We are unable to predict the effect of these matters at this time, although the effect could be adverse and material. These matters are reported in Note 16, Commitments and Contingencies, to the unaudited Condensed Consolidated Financial Statements, in Part II, Item 1, Legal Proceedings, and Item 1A, Risk Factors, which are incorporated herein by reference.

Outlook

For the full year of 2007, we expect mid-teens revenue growth, including the benefit from the Paxar acquisition, net of divestitures, and a positive effect from foreign currency translation. Our revenue expectations are subject to changes in economic and market conditions.

We estimate cost synergies associated with the Paxar integration, net of offsets, to be in the range of \$115 million to \$125 million. We expect approximately 30% to 40% of annualized savings to be realized by the first quarter of 2008, and approximately 90% of annualized savings to be realized by the first quarter of 2009. To accomplish these savings, we expect total estimated one-time Paxar integration costs to be in the range of \$175 million to \$210 million, of which approximately 85% are estimated to be cash costs. The nature and timing of these integration costs are being assessed in connection with integration planning, and as such, the amounts that will affect the purchase price allocation of Paxar and current period costs are not yet determined.

We anticipate continued benefit from our ongoing productivity improvement initiatives. Excluding synergies resulting from the Paxar integration, we estimate that our restructuring and business realignment efforts will reduce costs by approximately \$40 million compared to 2006. However, we plan to reinvest some of the savings from these productivity improvements in growth initiatives and investments in information technology. We also expect the benefits from productivity to be partially offset by inflation, as well as a more competitive pricing environment in our roll materials business.

We expect that total charges for restructuring and asset impairment (unrelated to the Paxar integration) for the full year of 2007 will be less than the charges taken in 2006.

We estimate that interest expense will be approximately \$105 million, an increase from 2006, driven by acquisition-related debt. Our estimate is subject to changes in average debt outstanding and market conditions at the time the permanent long-term financing for the acquisition-related debt is completed.

We expect our annual effective tax rate for the full year of 2007 to be in the range of 20% to 22%, subject to changes in tax laws and the geographic mix of income, with potentially wide variances from quarter to quarter.

Due to the difficulty in estimating investments in connection with the integration of Paxar, we have excluded spending related to Paxar in our current capital spending projections for the remainder of 2007. Accordingly, we expect capital expenditures for the full year of 2007 to be approximately \$165 million to \$170 million, or approximately \$215 million to \$230 million including software investments, funded through operating cash flows. Major capital projects in 2007 include expansion in China and India, serving both our materials and retail information services businesses. Major software investments relate to customer service and standardization initiatives.

ANALYSIS OF RESULTS OF OPERATIONS FOR THE SECOND QUARTER**Income from Continuing Operations Before Taxes**

(In millions)	2007	2006
Net sales	\$ 1,523.5	\$ 1,409.7
Cost of products sold	1,113.7	1,016.7
Gross profit	409.8	393.0
Marketing, general and administrative expense	270.8	251.3
Interest expense	20.1	13.6
Other expense, net	7.5	4.0
Income from continuing operations before taxes	\$ 111.4	\$ 124.1

As a Percent of Sales:

Gross profit (margin)	26.9%	27.9%
Marketing, general and administrative expense	17.8	17.8
Income from continuing operations before taxes	7.3	8.8

23

Table of Contents

Avery Dennison Corporation

Sales

Sales increased approximately 8% in the second quarter of 2007 compared to the second quarter of 2006. Organic sales growth was approximately 2% in the second quarter of 2007 reflecting increased sales in our Pressure-sensitive Materials segment and other specialty converting businesses due to strong international demand, partially offset by organic declines in sales for our Retail Information Services and Office and Consumer Products segments. Foreign currency translation had a favorable impact on the change in sales of approximately \$47 million in the second quarter of 2007. Incremental sales from acquisitions had a positive impact of approximately \$37 million in the second quarter of 2007 attributable to the acquisition of Paxar.

Gross Profit

Gross profit margin for the second quarter of 2007 declined compared to the first quarter of 2006, as savings from prior year restructuring and other sources of productivity, as well as the impact of the Paxar acquisition, were more than offset by the effects of a more competitive pricing environment and unfavorable product mix in the roll materials business, higher raw material costs, transition costs associated with cost reduction initiatives and employee-related costs.

Marketing, General and Administrative Expenses

The increase in marketing, general and administrative expense in the second quarter of 2007 compared to the same period last year primarily reflected costs from the Paxar acquisition and related integration expense (totaling approximately \$20 million, of which approximately \$8 million represents integration costs). Excluding the effects of the acquisition, the benefit from productivity and other cost reductions offset the negative effects of foreign currency translation (approximately \$7 million) and employee-related costs.

Other Expense, net

(In millions, pretax)	2007	2006
Restructuring costs	\$.9	\$ 4.7
Asset impairment		1.4
Asset impairment acquisition integration-related	9.5	
Other	(2.9)	(2.1)
Other expense, net	\$ 7.5	\$ 4.0

In the second quarter of 2007, Other expense, net consisted of software impairment charges related to the integration of Paxar, restructuring costs including severance and other employee-related costs, as well as expenses related to a divestiture (\$.3 million), partially offset by the reversal of an accrual related to a patent lawsuit (\$3.2 million). The restructuring costs in the second quarter of 2007 relate to a reduction in headcount of approximately 20 positions in the Pressure-sensitive Materials and Retail Information Services segments, which was completed in the same quarter. In the second quarter of 2006, Other expense, net consisted of charges for restructuring, including severance and other employee-related costs and asset impairment costs, as well as the gain on sale of an investment of \$10.5 million, partially offset by a charitable contribution to the Avery Dennison Foundation of \$10 million, and a gain on the curtailment and settlement of a pension obligation related to a divestiture of \$1.6 million. Restructuring charges in the second quarter of 2006 relate to a reduction in headcount of approximately 130 positions, which impacted most of our segments. These charges were part of the company-wide cost reduction efforts begun in late 2005 and completed in 2006.

Refer to Note 11, Cost Reduction Actions, to the unaudited Condensed Consolidated Financial Statements for more information.

Net Income and Earnings per Share

(In millions, except per share)	2007	2006
---------------------------------	------	------

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

Income from continuing operations before taxes	\$ 111.4	\$ 124.1
Taxes on income	25.6	27.7
Income from continuing operations	85.8	96.4
Income from discontinued operations, net of tax (including gain on disposal of \$1.3 and tax benefit of \$15.4 in 2006)		15.6
Net income	\$ 85.8	\$ 112.0
Net income per common share	\$.88	\$ 1.12
Net income per common share, assuming dilution	\$.87	\$ 1.12

24

Table of Contents

	Avery Dennison Corporation	
(In millions, except per share)	2007	2006
Net income as a percent of sales	5.6%	7.9%
Percent change in:		
Net income	(23.4)%	25.3%
Net income per common share	(21.4)	25.8
Net income per common share, assuming dilution	(22.3)	25.8

Taxes on Income

Our effective tax rate from continuing operations for the second quarter of 2007 was 23% compared with 22.3% for the same period in 2006, and 17.2% for the full year of 2006. The effective tax rate for the second quarter of 2007 includes the net benefit of \$.2 million from discrete events.

Income from Discontinued Operations

Income from discontinued operations reflects net sales of our divested raised reflective pavement marker business, which was approximately \$3 million for the second quarter of 2006. The divestiture resulted in a tax benefit (\$15.4 million) due to capital losses arising from the sale of the business and a gain on sale of \$1.3 million reported in the second quarter of 2006. Refer to Note 3, Discontinued Operations, to the unaudited Condensed Consolidated Financial Statements for more information.

RESULTS OF OPERATIONS BY SEGMENT FOR THE SECOND QUARTER**Pressure-sensitive Materials Segment**

(In millions)	2007	2006
Net sales including intersegment sales	\$ 920.8	\$ 848.2
Less intersegment sales	(41.5)	(38.7)
Net sales	\$ 879.3	\$ 809.5
Operating income ⁽¹⁾	88.9	77.4

⁽¹⁾ Includes reversal of an accrual related to a patent lawsuit in 2007, asset impairment charges in 2006, and restructuring costs in both years

\$ (2.7)	\$ 2.1
----------	--------

Net Sales

Sales in our Pressure-sensitive Materials segment increased 9% in the second quarter of 2007 compared to the second quarter in 2006, reflecting the positive impact of foreign currency translation (approximately \$36 million) and organic sales growth of approximately 4%, driven by international growth in both our roll materials and graphics and reflective businesses.

Our roll materials business in Europe experienced mid single-digit organic sales growth compared to the second quarter last year, which reflected strong growth in the east and solid growth in the west. On an organic basis, market expansion contributed to double-digit growth in the roll materials businesses in Asia and Latin America. Our North American roll materials business remained relatively flat compared to the second quarter last year, as continued weakness in market demand was offset by some share gain.

Our graphics and reflective business experienced low single-digit organic sales growth due to international growth, partially offset by a decline in the U.S.

Operating Income

Increased operating income in the second quarter of 2007 reflected higher sales and cost savings from restructuring and productivity improvement initiatives, partially offset by a more competitive pricing environment and unfavorable product mix in the roll materials business, higher raw material costs and transition costs related to restructuring actions. Operating income for the second quarter of 2007 and 2006 included restructuring costs and other items as described above in the table.

Retail Information Services Segment

(In millions)	2007	2006
Net sales including intersegment sales	\$ 219.4	\$ 182.5
Less intersegment sales	(.3)	(1.1)
Net sales	\$ 219.1	\$ 181.4
Operating income ^{(1) (2)}	.6	21.0

25

Table of Contents

Avery Dennison Corporation

(In millions)	2007	2006
(1) Includes integration-related software impairment in 2007 and restructuring costs in both years	\$ 9.9	\$ 2.0
(2) Includes integration costs related to the Paxar acquisition in 2007	\$ 8.3	\$

Net Sales

Sales in our Retail Information Services segment increased 21% in the second quarter of 2007 compared to the second quarter in 2006, which included sales from the Paxar acquisition (approximately \$37 million) and the positive impact of foreign currency translation (approximately \$3 million). On an organic basis, the sales declined approximately 1% reflecting lower sales in the woven label and fastener product lines, as well as market weakness in the U.S. and share loss in Europe.

Operating Income

Decreased operating income in the second quarter of 2007 reflected software impairment charges and integration costs associated with the Paxar acquisition, higher spending on investments in information technology and employee-related costs in Asia, and complexity-related cost increases due to smaller order sizes. Higher costs were partially offset by savings from restructuring and productivity initiatives. Operating income for the second quarter of 2007 and 2006 also included restructuring costs.

Office and Consumer Products Segment

(In millions)	2007	2006
Net sales including intersegment sales	\$ 263.1	\$ 265.9
Less intersegment sales	(.4)	(.5)
Net sales	\$ 262.7	\$ 265.4
Operating income ⁽¹⁾	42.3	45.3

(1) Includes expense related to a divestiture in 2007 and gain on curtailment and settlement of a pension obligation in 2006

	\$.3	\$ (1.6)
--	-------	----------

Net Sales

Sales in our Office and Consumer Products segment decreased 1% in the second quarter of 2007 compared to the second quarter in 2006. This decline in reported sales reflected lower sales on an organic basis, partially offset by the positive impact of foreign currency translation (approximately \$5 million). On an organic basis, sales declined 3%. This decline was due in part to inventory reductions resulting from a volume shift to the fourth quarter of 2006 in advance of the January 2007 selling price increases for certain product lines and loss of sales from exiting certain private label business, partially offset by a shift in timing of back-to-school orders from the third quarter into the second quarter of 2007.

Operating Income

Decreased operating income in the second quarter of 2007 reflected lower sales and the other items described above in the table, partially offset by savings from restructuring actions, net of transition costs, and productivity initiatives.

Other specialty converting businesses

(In millions)	2007	2006
---------------	------	------

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

Net sales including intersegment sales	\$ 167.6	\$ 157.0
Less intersegment sales	(5.2)	(3.6)
Net sales	\$ 162.4	\$ 153.4
Operating income ⁽¹⁾	6.9	4.6

⁽¹⁾ Includes restructuring costs in 2006 \$.7

Net Sales

Sales in our other specialty converting businesses increased 6% in the second quarter of 2007 compared to the second quarter of 2006. Reported sales growth included the positive impact of foreign currency translation (approximately \$3 million) and incremental sales from a small acquisition. Organic sales growth during the second quarter of 2007 was approximately 3%, including the negative impact of exiting low-margin business in our specialty tape business.

Operating Income

Increased operating income in the second quarter of 2007 was due to higher sales and a reduction in operating loss from the radio-

Table of Contents

Avery Dennison Corporation

frequency identification division. Operating income for the second quarter of 2006 included restructuring costs.

ANALYSIS OF RESULTS OF OPERATIONS FOR THE SIX MONTHS YEAR-TO-DATE**Income from Continuing Operations Before Taxes**

(In millions)	2007	2006
Net sales	\$ 2,913.4	\$ 2,746.9
Cost of products sold	2,139.2	1,998.7
Gross profit	774.2	748.2
Marketing, general and administrative expense	519.1	496.1
Interest expense	35.2	28.1
Other expense, net	9.6	11.6
Income from continuing operations before taxes	\$ 210.3	\$ 212.4
 <i>As a Percent of Sales:</i>		
Gross profit (margin)	26.6%	27.2%
Marketing, general and administrative expense	17.8	18.1
Income from continuing operations before taxes	7.2	7.7

Sales

Sales increased approximately 6% in the first six months of 2007 compared to the same period in the prior year. Organic sales growth was approximately 2% in the first six months of 2007, which reflected increased sales in our Pressure-sensitive Materials segment and other specialty converting businesses. The growth in Pressure-sensitive Materials and other specialty converting businesses was offset by organic declines in sales for our Retail Information Services and Office and Consumer Products segments.

Foreign currency translation had a favorable impact on the change in sales of approximately \$94 million in the first six months of 2007. Incremental sales from acquisitions, net of product line divestitures, had a positive impact of \$27 million in the first six months of 2007.

Gross Profit

Gross profit margin for the first six months of 2007 declined compared to the same period last year, as benefits from restructuring actions and other productivity improvements and impact of the Paxar acquisition were more than offset by the effect of a more competitive pricing environment and unfavorable product mix in the roll materials business, unfavorable segment mix (segments with lower gross profit margin representing a higher percentage of total sales), higher raw material costs, employee-related costs, and transition costs associated with new productivity improvement actions.

Marketing, General and Administrative Expenses

The increase in marketing, general and administrative expense in the first six months of 2007 compared to the same period last year primarily reflected costs from the Paxar acquisition and related integration expense (totaling approximately \$20 million, of which \$8 million represent integration costs). The impact of foreign currency translation (approximately \$13 million) was mostly offset by savings from restructuring actions and other cost reductions.

Other Expense, net

(In millions, pretax)	2007	2006
-----------------------	------	------

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

Restructuring costs	\$ 3.0	\$ 10.1
Asset impairment		3.2
Asset impairment acquisition integration-related	9.5	
Other	(2.9)	(1.7)
Other expense, net	\$ 9.6	\$ 11.6

In the first six months of 2007, Other expense, net consisted of charges for software asset impairment related to the integration of Paxar, restructuring costs including severance and other employee-related costs, and expenses related to a divestiture (\$.3 million), partially offset by a reversal of an accrual related to a patent lawsuit (\$3.2 million).

Restructuring charges in the first six months of 2007 relate to a reduction in headcount of approximately 95 positions, which impacted each of our segments.

In the first six months of 2006, Other expense, net consisted of charges for restructuring, including severance and other employee-related costs and asset impairment costs, a gain on curtailment and settlement of a pension obligation (\$1.6 million), an accrual for legal fees related to a patent lawsuit (\$.4 million), and a gain on sale of investment (\$10.5 million), partially offset by a charitable

Table of Contents

Avery Dennison Corporation

contribution to Avery Dennison Foundation (\$10 million). Restructuring charges in the first six months of 2006 relate to a reduction in headcount of approximately 230 positions, which impacted all of our segments. These charges were part of the company-wide cost reduction efforts begun in late 2005 and completed in 2006. Refer to Note 11, Cost Reduction Actions, to the unaudited Condensed Consolidated Financial Statements for more information.

Net Income and Earnings per Share

(In millions, except per share)	2007	2006
Income from continuing operations before taxes	\$ 210.3	\$ 212.4
Taxes on income	45.3	47.1
Income from continuing operations	165.0	165.3
Income from discontinued operations, net of tax (including gain on disposal of \$1.3 and tax benefit of \$15.4 in 2006)		15.4
Net income	\$ 165.0	\$ 180.7
Net income per common share	\$ 1.68	\$ 1.81
Net income per common share, assuming dilution	\$ 1.67	\$ 1.80
Net income as a percent of sales	5.7%	6.6%
Percent change in:		
Net income	(8.7)%	22.8%
Net income per common share	(7.2)	23.1
Net income per common share, assuming dilution	(7.2)	23.3

Taxes on Income

Our effective tax rate from continuing operations for the first six months of 2007 was 21.5% compared with 22.2% for the same period in 2006, and 17.2% for the full year of 2006. The effective tax rate for the first six months of 2007 includes the net benefit of \$3 million from discrete events, including the release of tax contingencies, partially offset by accruals relating to tax return filings and valuation allowances.

Income from Discontinued Operations

Income from discontinued operations reflects net sales of our divested raised reflective pavement marker business, which was approximately \$7 million for the first six months of 2006. The divestiture resulted in a tax benefit (\$15.4 million) due to capital losses arising from the sale of the business and a gain on sale of \$1.3 million reported in the second quarter of 2006. Refer to Note 3, Discontinued Operations, to the unaudited Condensed Consolidated Financial Statements for more information.

RESULTS OF OPERATIONS BY SEGMENT FOR THE SIX MONTHS YEAR-TO-DATE**Pressure-sensitive Materials Segment**

(In millions)	2007	2006
Net sales including intersegment sales	\$ 1,815.9	\$ 1,673.9

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

Less intersegment sales	(76.6)	(77.2)
Net sales	\$ 1,739.3	\$ 1,596.7
Operating income ⁽¹⁾	170.8	143.3

⁽¹⁾ Includes reversal of accrual related to patent lawsuit in 2007, asset impairment charges and accrual for legal fees related to patent lawsuit in 2006, and restructuring costs in both years

\$	(1.2)	\$	6.1
----	-------	----	-----

Net Sales

Sales in our Pressure-sensitive Materials segment increased 9% in the first six months of 2007 compared to the same period in 2006 reflecting organic sales growth and the positive impact of foreign currency translation (approximately \$70 million). Organic sales growth of approximately 4% reflected international growth in both our roll materials and graphics and reflective businesses.

Our roll materials business in Europe experienced mid single-digit organic sales growth, which reflected strong growth in the east and solid growth in the west. On an organic basis, market expansion contributed to double-digit organic sales growth in the roll materials businesses in Asia and Latin America. Partially offsetting this growth, our North American roll materials business experienced a low

Table of Contents

Avery Dennison Corporation

single-digit decline in sales, reflecting slow market conditions during the first half of 2007.

Our graphics and reflective business experienced low single-digit organic sales growth due to international growth, partially offset by a decline in the U.S.

Operating Income

Increased operating income in the first six months of 2007 reflected higher sales and cost savings from restructuring and productivity improvement initiatives, partially offset by a more competitive pricing environment and unfavorable product mix in the roll materials business, higher raw material costs and transition costs related to restructuring actions. Operating income for both years included restructuring costs and other items as described above in the table.

Retail Information Services Segment

(In millions)	2007	2006
Net sales including intersegment sales	\$ 376.2	\$ 337.0
Less intersegment sales	(.8)	(1.8)
Net sales	\$ 375.4	\$ 335.2
Operating income ⁽¹⁾⁽²⁾	7.8	28.6

⁽¹⁾ Includes integration-related software impairment in 2007, asset impairment in 2006, and restructuring costs in both years

\$ 9.9	\$ 4.3
--------	--------

⁽²⁾ Includes integration costs related to the Paxar acquisition in 2007

\$ 8.3	\$
--------	----

Net Sales

Sales in our Retail Information Services segment increased 12% in the first six months of 2007 compared to the same period last year, which included sales from the Paxar acquisition (approximately \$37 million) and the positive impact of foreign currency translation (approximately \$7 million). On an organic basis, sales declined approximately 1% reflecting lower sales in the woven label and fastener product lines, and market weakness in the U.S.

Operating Income

Decreased operating income in the first six months of 2007 reflected software impairment charges and integration costs associated with the Paxar acquisition, higher spending on investments in information technology and employee-related costs in Asia, partially offset by savings from restructuring and productivity initiatives. Operating income in both years included restructuring costs and other items as described above in the table.

Office and Consumer Products Segment

(In millions)	2007	2006
Net sales including intersegment sales	\$ 477.9	\$ 506.3
Less intersegment sales	(.8)	(1.0)
Net sales	\$ 477.1	\$ 505.3
Operating income ⁽¹⁾	68.8	81.1

⁽¹⁾ Includes expense related to a divestiture in 2007, gain on curtailment and settlement of a pension obligation in 2006, and restructuring costs in both years

\$.9	\$ (.8)
-------	---------

Net Sales

Sales in our Office and Consumer Products segment decreased 6% in the first six months of 2007 compared to the same period in 2006. This decline in reported sales reflected lower sales on an organic basis, as well as the impact of product line divestiture (approximately \$9 million), partially offset by the positive impact of foreign currency translation (approximately \$10 million). On an organic basis, sales declined 6% in the first six months of 2007 due to a volume shift to the fourth quarter of 2006 in advance of the January 2007 selling price increases for certain product lines and the related inventory reductions, customer inventory reductions (unrelated to the 2006 volume shift) and the loss of sales from exiting certain private label business, partially offset by a shift in timing of back-to-school orders from the third quarter into the second quarter of 2007.

Operating Income

Decreased operating income in the first six months of 2007 reflected lower sales and transition costs associated with a product line divestiture and restructuring actions, partially offset by savings from previous restructuring actions and productivity initiatives.

Table of Contents

Avery Dennison Corporation

Operating income in both years included restructuring costs and other items as described above in the table.

Other specialty converting businesses

(In millions)	2007	2006
Net sales including intersegment sales	\$ 330.7	\$ 316.4
Less intersegment sales	(9.1)	(6.7)
Net sales	\$ 321.6	\$ 309.7
Operating income ⁽¹⁾	17.8	10.8
⁽¹⁾ Includes restructuring costs in 2006	\$	\$.7

Net Sales

Sales in our other specialty converting businesses increased 4% in the first six months of 2007 compared to the same period last year. Reported sales growth included the positive impact of foreign currency translation (approximately \$7 million), partially offset by the impact of a product line divestiture, net of a small acquisition (approximately \$2 million). Organic sales growth during the first six months of 2007 was approximately 2%, including the negative impact of exiting low-margin business in our specialty tape business.

Operating Income

Increased operating income in the first six months of 2007 was due to higher sales, savings from restructuring and productivity initiatives, and a reduction in operating loss from the radio frequency identification division. Operating income in 2006 included restructuring costs.

FINANCIAL CONDITION**Liquidity****Cash Flow Provided by Operating Activities for the First Six Months:**

(In millions)	2007	2006
Net income	\$ 165.0	\$ 180.7
Depreciation and amortization	100.8	99.2
Deferred taxes	3.4	3.7
Asset impairment and net loss (gain) on sale and disposal of assets	13.1	(6.1)
Stock-based compensation and other non-cash items, net	.4	6.7
Changes in assets and liabilities, net of the effect of business acquisitions and divestitures	(151.8)	(151.2)
Net cash provided by operating activities	\$ 130.9	\$ 133.0

For cash flow purposes, changes in assets and liabilities exclude the impact of foreign currency translation, the impact of acquisitions and divestitures and certain non-cash transactions (discussed in the Analysis of Selected Balance Sheet Accounts section below).

In 2007, cash flow provided by operating activities was negatively impacted by changes in working capital, as shown below:

Uses of cash

Trade accounts receivable reflected the seasonal sales volume, including back-to school, and increase in the average days sales outstanding reflecting the timing of receipts from customers

Accounts payable and accrued liabilities reflected the timing of payments, including payments for trade rebates and bonuses

Inventory reflected increased purchases to support increase in volume and seasonality

Sources of cash

Other receivables primarily reflected the timing of collection of value-added tax receivables in Europe
In 2006, cash flow provided by operating activities was negatively impacted by changes in working capital, as shown below:

Uses of cash

Accounts payable and accrued liabilities reflected the timing of payments, including payments for trade rebates, bonuses and severance and related benefits

Inventory reflected build of inventory for the back-to-school season in North America and other seasonal effects

Long-term retirement benefits and other liabilities reflected contributions of approximately \$28 million to our pension and postretirement health benefit plans during the first three months of 2006, partially offset by benefit payments

Table of Contents

Avery Dennison Corporation

Taxes on income (payable and receivable) due to the timing of payments and accruals

Cash Flow Used in Investing Activities for the First Six Months:

(In millions)	2007	2006
Purchase of property, plant and equipment	\$ (94.7)	\$ (80.5)
Purchase of software and other deferred charges	(29.0)	(15.7)
Payments for acquisitions	(1,284.1)	
Proceeds from sale of assets	1.7	.9
Proceeds from sale of businesses and investments		29.3
Other	.7	(.8)
Net cash used in investing activities	\$ (1,405.4)	\$ (66.8)

Payments for acquisitions

On June 15, 2007, we completed the acquisition of Paxar, a global leader in retail tag, ticketing, and branding systems. In accordance with the terms of the acquisition agreement, each outstanding share of Paxar common stock, par value \$0.10 (other than shares owned by the Company and its subsidiaries) was converted into the right to receive \$30.50 in cash. The total purchase price for this transaction was approximately \$1.33 billion, including transaction costs of approximately \$14 million. Cash paid for acquisitions is reported net of cash acquired of approximately \$47 million. Funds to complete the acquisition were derived from commercial paper borrowings, supported by a bridge revolving credit facility. Refer to Note 2, Acquisitions, to the unaudited Condensed Consolidated Financial Statements for more information.

Capital Spending

Our major capital projects in 2007 include investments for expansion in China and India serving both our materials and retail information services businesses. Our major information technology projects in 2007 include customer service and standardization initiatives.

Proceeds from Sale of Businesses and Investments

In 2006, we sold a long-term investment (proceeds of approximately \$16 million), divested our raised reflective pavement marker business in the U.S. (proceeds of approximately \$9 million), and divested a product line in Europe (proceeds of approximately \$4 million).

Cash Flow Used in Financing Activities for the First Six Months:

(In millions)	2007	2006
Net change in borrowings and payments of debt	\$ 1,412.2	\$ (57.1)
Dividends paid	(85.4)	(85.7)
Purchase of treasury stock	(63.2)	
Proceeds from exercise of stock options, net	30.5	18.6
Other	(2.1)	8.0
Net cash provided by (used in) financing activities	\$ 1,292.0	\$ (116.2)

Borrowings and Repayment of Debt

During the first six months of 2007, we increased our short-term borrowings to fund the Paxar acquisition transaction, as noted above in *Payments for acquisitions*. Additionally, proceeds from borrowings were used to support seasonal operational requirements and share repurchases.

Shareholders Equity

Our shareholders' equity was \$1.82 billion at June 30, 2007 compared to \$1.66 billion at July 1, 2006. Our dividend per share increased to \$.80 in the first six months of 2007 from \$.78 in the first six months of 2006.

Shares Repurchases

During the first six months of 2007, we repurchased approximately .8 million shares totaling \$52 million. We also made cash payments of \$11 million related to shares repurchased in 2006, but settled in 2007.

Analysis of Selected Balance Sheet Accounts

Long-lived Assets

Goodwill increased approximately \$852 million during the first six months of 2007 due to preliminarily identified goodwill associated with the Paxar acquisition completed in June 2007 (\$840 million), and foreign currency translation (\$12 million), partially offset by a

Table of Contents

Avery Dennison Corporation

tax adjustment related to a previous acquisition (less than \$1 million).

Other intangible assets resulting from business acquisitions increased approximately \$256 million during the first six months of 2007 due to the intangible assets preliminarily identified from the Paxar acquisition (\$261 million), and the impact of foreign currency translation (\$1 million), partially offset by amortization expense (\$6 million).

Refer to Note 2, Acquisitions, to the unaudited Condensed Consolidated Financial Statements for more information.

Other assets increased approximately \$10 million during the first six months of 2007 due primarily to purchases of software and other deferred charges (\$29 million) and an increase in the cash surrender value of corporate-owned life insurance (\$11 million), partially offset by normal amortization of software and other deferred charges (\$15 million), software asset impairment (\$9 million), and change in long-term pension assets (\$7 million).

Other Shareholders' Equity Accounts

The value of our employee stock benefit trusts decreased approximately \$55 million during the first six months of 2007 due to the issuance of shares under our stock option and incentive plans of approximately \$42 million, and a decrease in the market value of shares held in the trust of approximately \$13 million.

Impact of Foreign Currency Translation for the First Six Months:

(In millions)	2007	2006
Change in net sales	\$ 94	\$ (39)
Change in net income	5	(2)

International operations generated approximately 60% of our net sales in the first six months of 2007. Our future results are subject to changes in political and economic conditions and the impact of fluctuations in foreign currency exchange.

The benefit to sales from currency translation in the first six months of 2007 primarily reflected a benefit of the Euro, and currencies in Great Britain, Australia, and China.

Effect of Foreign Currency Transactions

The impact on net income from transactions denominated in foreign currencies is reduced because our products are generally sourced in the currencies in which they are sold. In addition, to reduce our income statement exposure to transactions in foreign currencies, we enter into foreign exchange forward, option and swap contracts, where available and appropriate.

Analysis of Selected Financial Ratios

We utilize certain financial ratios to assess our financial condition and operating performance, as discussed below.

Operational Working Capital Ratio

Working capital (current assets minus current liabilities, excluding working capital of held-for-sale business), as a percent of annualized net sales, decreased in 2007 primarily due to an increase in short-term debt. Operational working capital from continuing operations, as a percent of annualized net sales, is a non-GAAP measure and is shown below. We use this non-GAAP measure as a tool to assess our working capital requirements because it excludes the impact of fluctuations due to financing and other activities (that affect cash and cash equivalents, deferred taxes and other current assets and other current liabilities) that tend to be disparate in amount and timing and therefore, may increase the volatility of the working capital ratio from period to period. Additionally, the items excluded from this measure are not necessarily indicative of the underlying trends of the operations and are not significantly influenced by the day-to-day activities that are managed at the operating level. Refer to Uses and Limitations of Non-GAAP Measures. Our objective is to minimize our investment in operational working capital, as a percentage of sales, by reducing this ratio, to maximize cash flow and return on investment.

Operational working capital from continuing operations for the first six months:

(In millions)	2007	2006
---------------	------	------

Edgar Filing: AVERY DENNISON CORPORATION - Form 10-Q

(A) Working capital (current assets minus current liabilities; excludes working capital of held-for-sale businesses)	\$ (1,080.0)	\$ 148.4
Reconciling items:		
Cash and cash equivalents	(76.6)	(49.1)
Deferred taxes and other current assets	(269.8)	(160.8)

32

Table of Contents

	Avery Dennison Corporation	
(In millions)	2007	2006
Short-term and current portion of long-term debt	1,894.3	326.5
Other current liabilities	615.6	507.5
(B) Operational working capital from continuing operations	\$ 1,083.5	\$ 772.5
(C) Annualized net sales (year-to-date sales, multiplied by 2)	\$ 5,826.8	\$ 5,493.8
Working capital, as a percent of annualized net sales (A) , (C)	(18.5)%	2.7%
Operational working capital from continuing operations as a percent of annualized net sales (B) , (C)	18.6%	14.1%

As a percent of annualized sales, operational working capital from continuing operations in the first six months of 2007 increased compared to the same period in the prior year. This change, which includes the impact of currency, is discussed below.

Accounts Receivable Ratio

The average number of days sales outstanding was 65 days in the first six months of 2007 compared to 58 days in the first six months of 2006, calculated using the two-quarter average trade accounts receivable balance divided by the average daily sales for the first six months. The change is primarily due to the acquisition of Paxar, as well as timing of sales and collection.

Inventory Ratio

Average inventory turnover was 7.5 in the first six months of 2007 compared to 8.5 in the first six months of 2006, calculated using the annualized cost of sales (cost of sales for the first six months multiplied by 2) divided by the inventory balance at quarter-end. The change is primarily due to the acquisition of Paxar, as well as higher material costs.

Accounts Payable Ratio

The average number of days payable outstanding was 56 days in the first six months of 2007 compared to 55 days in the first six months of 2006, calculated using the two-quarter average accounts payable balance divided by the average daily cost of products sold for the first six months. The change is primarily due to the acquisition of Paxar, partially offset by the timing of payments in Europe.

Debt and Shareholders' Equity Ratios

	Six Months Ended	
	June 30, 2007	July 1, 2006
Total debt to total capital	56.8%	38.6%
Return on average shareholders' equity	19.0	22.9
Return on average total capital	11.9	15.2

The increase in the total debt to total capital ratio was primarily due to an increase in short-term borrowings related to the Paxar acquisition, partially offset by an increase in shareholders' equity.

Decreases in the returns on shareholders' equity and total capital in the first six months of 2007 compared to the first six months of 2006 were primarily due to lower net income, and higher equity and total debt outstanding. These ratios are computed using annualized net income (year-to-date net income multiplied by 2) and a three-quarter average

denominator for equity and total debt accounts.

Capital Resources

Capital resources include cash flows from operations and debt financing. We maintain adequate financing arrangements at competitive rates. These financing arrangements consist of our commercial paper programs in the U.S. and Europe, committed and uncommitted bank lines of credit in the countries where we operate, callable commercial notes and long-term debt, including medium-term notes.

Capital from Debt

Our total debt increased approximately \$1.43 billion in the first six months of 2007 to \$2.4 billion compared to \$968 million at year end 2006, reflecting increased short-term borrowings primarily related to the Paxar acquisition during the second quarter of 2007, seasonal operational requirements and share repurchases, as well as the impact of foreign currency translation.

We funded the Paxar acquisition by issuing commercial paper, supported by a bridge revolving credit facility. We intend to refinance a portion of these borrowings through the issuance of long-term debt.

Credit ratings are a significant factor in our ability to raise short-term and long-term financing. The credit ratings assigned to us also impact the interest rates on our commercial paper and other borrowings. When determining a credit rating, the rating agencies place significant weight on our competitive position, business outlook, consistency of cash flows, debt level and liquidity, geographic dispersion and management team.

Table of Contents

Avery Dennison Corporation

Our credit ratings as of June 30, 2007:

	Short-term	Long-term	Outlook
Standard & Poor's Rating Service (S&P)	A-2	BBB+	Watch Negative
Moody's Investors Service (Moody's)	P2	A3	Under Review

Both rating agencies have placed our ratings under review due to the recent acquisition of Paxar. S&P lowered our long-term rating from A- to BBB+ due to the incremental debt incurred as a result of the Paxar acquisition. Moody's has not yet announced the ratings impact of the Paxar acquisition-related debt. We remain committed to retaining a solid investment grade rating.

Off-Balance Sheet Arrangements, Contractual Obligations, and Other Matters*Industry Investigations*

On June 18, 2007, we were notified by the Canadian Department of Justice that the Competition Law Division of the Canadian Department of Justice had decided to close its criminal investigation (initiated in July 2004) into competitive practices in the label stock industry without further action.

On November 15, 2006, we announced that we had been notified by the EC that the EC had closed its investigation (initiated in May 2004) into competitive activities in the label stock industry with no action.

On October 19, 2006, we were notified by the DOJ that the DOJ had decided to close its criminal investigation (initiated in April 2003) into competitive practices in the label stock industry without further action.

In August 2005, we were notified by the Australian Competition and Consumer Commission that it was seeking information in connection with a label stock investigation. We are cooperating with this investigation.

We are a named defendant in purported class actions in the U.S. seeking treble damages and other relief for alleged unlawful competitive practices, which were filed after the announcement of the DOJ investigation. We are also a named defendant in purported class actions in the U.S. seeking damages and other relief for alleged disclosure and fiduciary duty violations pertaining to alleged unlawful competitive practices.

We are unable to predict the effect of these matters at this time, although the effect could be adverse and material.

These and other matters are reported in Note 16, Commitments and Contingencies, to the unaudited Condensed Consolidated Financial Statements, in Part II, Item 1, Legal Proceedings, and Item 1A, Risk Factors, which are incorporated herein by reference.

Environmental

We have been designated by the U.S. Environmental Protection Agency (EPA) and/or other responsible state agencies as a potentially responsible party (PRP) at eighteen waste disposal or waste recycling sites, including Paxar sites, which are the subject of separate investigations or proceedings concerning alleged soil and/or groundwater contamination and for which no settlement of our liability has been agreed upon. We are participating with other PRPs at such sites, and anticipate that our share of cleanup costs will be determined pursuant to remedial agreements to be entered into in the normal course of negotiations with the EPA or other governmental authorities.

We have accrued liabilities for these and certain other sites, including sites in which governmental agencies have designated us as a PRP, where it is probable that a loss will be incurred and the cost or amount of loss can be reasonably estimated. However, because of the uncertainties associated with environmental assessment and remediation activities, future expense to remediate the currently identified sites and any sites which could be identified in the future for cleanup could be higher than the liability currently accrued.

During the third quarter of 2006, we recognized additional liability of \$13 million for estimated environmental remediation costs for a former operating facility, for which \$2 million had been accrued in the second quarter of 2006. The amount accrued represents the lower end of the current estimated range of \$15 million to \$17 million for costs expected to be incurred. We considered additional information provided by outside consultants in revising our previous estimates of expected costs. This estimate could change depending on various factors such as modification of currently planned remedial actions, changes in the site conditions, a change in the estimated time to complete

remediation, changes in laws and regulations affecting remediation requirements and other factors. Other amounts currently accrued are not significant to our consolidated financial position, and based upon current information, we believe that it is unlikely that the final resolution of these matters will significantly impact our consolidated financial position, results of operations or cash flows.

Table of Contents

Avery Dennison Corporation

Other

In 2005, we contacted relevant authorities in the U.S. and reported the results of an internal investigation of potential violations of the U.S. Foreign Corrupt Practices Act. The transactions at issue were carried out by a small number of employees of our reflective business in China, and involved, among other things, impermissible payments or attempted impermissible payments. The payments or attempted payments and the contracts associated with them appear to have been relatively minor in amount and of limited duration. Corrective and disciplinary actions have been taken. Sales of our reflective business in China in 2005 were approximately \$7 million. Based on findings to date, no changes to our previously filed financial statements are warranted as a result of these matters. However, we believe that fines or other penalties may be incurred. While we are unable to predict the financial or operating impact of any such fines or penalties, we believe that our behavior in detecting, investigating, responding to and voluntarily disclosing these matters to authorities should be viewed favorably.

We and our subsidiaries are involved in various other lawsuits, claims and inquiries, most of which are routine to the nature of the business. Based upon current information, we believe that the resolution of these other matters will not materially affect us.

We provide for an estimate of costs that may be incurred under our basic limited warranty at the time product revenue is recognized. These costs primarily include materials and labor associated with the service or sale of products. Factors that affect our warranty liability include the number of units installed or sold, historical and anticipated rate of warranty claims on those units, cost per claim to satisfy our warranty obligation and availability of insurance coverage. As these factors are impacted by actual experience and future expectations, we assess the adequacy of the recorded warranty liability and adjust the amounts as necessary.

On September 9, 2005, we completed the lease financing for a commercial facility (the Facility) located in Mentor, Ohio, used primarily for the new headquarters and research center for our roll materials division. The Facility consists generally of land, buildings, equipment and office furnishings. We have leased the Facility under an operating lease arrangement, which contains a residual value guarantee of \$33.4 million. We do not expect the residual value of the Facility to be less than the amount guaranteed.

The Company participates in international receivable financing programs with several financial institutions whereby advances may be requested from these financial institutions. Such advances are guaranteed by the Company. At June 30, 2007, the Company had guaranteed approximately \$15 million.

As of June 30, 2007, we guaranteed up to approximately \$21 million of certain of our foreign subsidiaries' obligations to their suppliers.

USES AND LIMITATIONS OF NON-GAAP MEASURES

Our presented non-GAAP financial measures exclude the impact of certain events, activities or strategic decisions. The accounting effects of these events, activities or decisions, which are included in the GAAP measures, may make it difficult to assess the underlying performance of the Company in a single period. By excluding certain accounting effects, both positive and negative (e.g. gains on sales of assets, restructuring charges, asset impairments, etc.), from certain of our GAAP measures, management believes that it is providing meaningful supplemental information to facilitate an understanding of the Company's core or underlying operating results. These non-GAAP measures are used internally to evaluate trends in our underlying business, as well as to facilitate comparison to the results of competitors for a single period.

Limitations associated with the use of our non-GAAP measures include (1) the exclusion of foreign currency translation and the impact of acquisitions and divestitures for the calculation of organic sales growth; (2) the exclusion of mandatory debt service requirements, as well as the exclusion of other uses of the cash generated by operating activities that do not directly or immediately support the underlying business (such as discretionary debt reductions, dividends, share repurchase, acquisitions, etc.) for calculation of free cash flow; and (3) the exclusion of cash and cash equivalents, short-term debt, deferred taxes and other current assets and other current liabilities, as well as current assets and current liabilities of held-for-sale businesses, for the calculation of operational working capital. While some of the items the Company excludes from GAAP measures recur, these items tend to be disparate in amount and timing. Based upon feedback from investors and financial analysts, we believe that supplemental non-GAAP

measures provide information that is useful to the assessment of the Company's performance and operating trends.

RECENT ACCOUNTING REQUIREMENTS

During the first six months of 2007, certain other accounting and financial disclosure requirements by the Financial Accounting Standards Board (FASB) and the SEC were issued. Refer to Note 18, Recent Accounting Requirements, to the unaudited Condensed Consolidated Financial Statements for more information.

Table of Contents

Avery Dennison Corporation

SAFE HARBOR STATEMENT

The matters discussed in this Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Quarterly Report contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements, which are not statements of historical fact, may contain estimates, assumptions, projections and/or expectations regarding future events, which may or may not occur. Words such as aim, anticipate, assume, believe, continue, could, estimate, expect, guidance, intend, may, potential, project, seek, shall, should, target, will, would, or variations thereof and other expressions, which identify future events and trends, identify forward-looking statements. Such forward-looking statements, and financial or other business targets, are subject to certain risks and uncertainties, which could cause actual results to differ materially from expected results, performance or achievements of the Company expressed or implied by such forward-looking statements.

Certain of such risks and uncertainties are discussed in more detail in Part II, Item 1A, Risk Factors, to this Form 10-Q for the quarter ended June 30, 2007 and Part I, Item 1A, Risk Factors, to the Company's Annual Report on Form 10-K for the year ended December 30, 2006, and include, but are not limited to, risks and uncertainties relating to investment in development activities and new production facilities; fluctuations in cost and availability of raw materials; ability of the Company to achieve and sustain targeted cost reductions, including synergies expected from the integration of the Paxar business in the time and the cost anticipated; ability of the Company to generate sustained productivity improvement; successful integration of acquisitions; successful implementation of new manufacturing technologies and installation of manufacturing equipment; the financial condition and inventory strategies of customers; customer and supplier concentrations; changes in customer order patterns; loss of significant contract(s) or customer(s); timely development and market acceptance of new products; fluctuations in demand affecting sales to customers; impact of competitive products and pricing; selling prices; business mix shift; credit risks; ability of the Company to obtain adequate financing arrangements; fluctuations in interest rates; fluctuations in pension, insurance and employee benefit costs; impact of legal proceedings, including the Australian Competition and Consumer Commission investigation into industry competitive practices, and any related proceedings or lawsuits pertaining to this investigation or to the subject matter thereof or of the recently concluded investigations by the U.S. Department of Justice (DOJ), the European Commission, and the Canadian Department of Justice (including purported class actions seeking treble damages for alleged unlawful competitive practices, and a purported class action related to alleged disclosure and fiduciary duty violations pertaining to alleged unlawful competitive practices, which were filed after the announcement of the DOJ investigation), as well as the impact of potential violations of the U.S. Foreign Corrupt Practices Act based on issues in China; changes in governmental regulations; changes in economic or political conditions; fluctuations in foreign currency exchange rates and other risks associated with foreign operations; worldwide and local economic conditions; impact of epidemiological events on the economy and the Company's customers and suppliers; acts of war, terrorism, natural disasters; and other factors.

The Company believes that the most significant risk factors that could affect its ability to achieve its stated financial expectations in the near-term include (1) the impact of economic conditions on underlying demand for the Company's products; (2) the impact of competitors' actions, including expansion in key markets, product offerings and pricing; (3) the degree to which higher raw material and energy-related costs can be passed on to customers through selling price increases (and previously implemented selling price increases can be sustained), without a significant loss of volume; (4) potential adverse developments in legal proceedings and/or investigations regarding competitive activities, including possible fines, penalties, judgments or settlements; and (5) the ability of the Company to achieve and sustain targeted cost reductions, including expected synergies associated with the Paxar acquisition.

The Company's forward-looking statements represent judgment only on the dates such statements were made. By making such forward-looking statements, the Company assumes no duty to update them to reflect new, changed or unanticipated events or circumstances, other than as may be required by law.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There are no material changes in the information provided in Part II, Item 7A of the Company's Form 10-K for the fiscal year ended December 30, 2006.

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(f)) that are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding the required disclosure.

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter

Table of Contents

Avery Dennison Corporation

how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily is required to apply its judgement in evaluating the cost-benefit relationship of possible controls and procedures.

The Company's disclosure controls system is based upon a global chain of financial and general business reporting lines that converge in the Company's headquarters in Pasadena, California. As required by SEC Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this report.

Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective to provide reasonable assurance that information is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding the required disclosure.

In connection with the acquisition of Paxar, the Company has performed certain due diligence procedures related to Paxar's financial reporting and disclosure controls. As part of the ongoing integration, the Company will continue to assess the overall control environment of this business.

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

37

Table of Contents

Avery Dennison Corporation

PART II. OTHER INFORMATION**ITEM 1. LEGAL PROCEEDINGS**

The Company has been designated by the U.S. Environmental Protection Agency (EPA) and/or other responsible state agencies as a potentially responsible party (PRP) at eighteen waste disposal or waste recycling sites, including Paxar sites, which are the subject of separate investigations or proceedings concerning alleged soil and/or groundwater contamination and for which no settlement of the Company's liability has been agreed. The Company is participating with other PRPs at such sites, and anticipates that its share of cleanup costs will be determined pursuant to remedial agreements entered into in the normal course of negotiations with the EPA or other governmental authorities.

The Company has accrued liabilities for these and certain other sites, including sites in which governmental agencies have designated the Company as a PRP, where it is probable that a loss will be incurred and the cost or amount of loss can be reasonably estimated. However, because of the uncertainties associated with environmental assessment and remediation activities, future expense to remediate the currently identified sites and any sites which could be identified in the future for cleanup could be higher than the liability currently accrued.

During the third quarter of 2006, the Company recognized additional liability of \$13 million for estimated environmental remediation costs for a former operating facility, for which \$2 million had been accrued in the second quarter of 2006. The amount accrued represents the lower end of the current estimated range of \$15 million to \$17 million for costs expected to be incurred. Management considered additional information provided by outside consultants in revising its previous estimates of expected costs. This estimate could change depending on various factors such as modification of currently planned remedial actions, changes in the site conditions, a change in the estimated time to complete remediation, changes in laws and regulations affecting remediation requirements and other factors.

Other amounts currently accrued are not significant to the consolidated financial position of the Company and, based upon current information, management believes it is unlikely that the final resolution of these matters will significantly impact the Company's consolidated financial position, results of operations or cash flows.

On June 18, 2007, the Canadian Department of Justice notified the Company that the Competition Law Division of the Canadian Department of Justice had decided to close its criminal investigation (initiated July 9, 2004) into competitive practices in the label stock industry without further action, as described below.

On November 15, 2006, the Company announced that it had been notified that the European Commission (EC) had closed its investigation (initiated in May 2004) into the Company's competitive activities in the label stock industry with no action, as described below.

On October 19, 2006, the U.S. Department of Justice (DOJ) notified the Company that the DOJ had decided to close its criminal investigation (initiated in April 2003) into competitive practices in the label stock industry without further action, as described below.

On April 14, 2003, the Company announced that it had been notified that the U.S. Department of Justice had initiated a criminal investigation into competitive practices in the label stock industry. The Company cooperated with the now closed investigation.

On April 15, 2003, the U.S. Department of Justice filed a complaint in the U.S. District Court for the Northern District of Illinois (DOJ Merger Complaint) seeking to enjoin the proposed merger of UPM-Kymmene (UPM) and the Morgan Adhesives (MACtac) division of Bemis Co., Inc. (Bemis). The DOJ Merger Complaint included references not only to the parties to the merger, but also to an unnamed Leading Producer of North American label stock, which is the Company. The DOJ Merger Complaint asserted that UPM and the Leading Producer have already attempted to limit competition between themselves, as reflected in written and oral communications to each other through high level executives regarding explicit anticompetitive understandings, although the extent to which these efforts have succeeded is not entirely clear to the United States at the present time. On July 25, 2003, the United States District Court for the Northern District of Illinois entered an order enjoining the proposed merger. UPM and Bemis thereafter agreed to terminate the merger agreement.

On April 24, 2003, Sentry Business Products, Inc. filed a purported class action in the United States District Court for the Northern District of Illinois against the Company, UPM, Bemis and certain of their subsidiaries seeking treble

damages and other relief for alleged unlawful competitive practices, essentially repeating the underlying allegations of the DOJ Merger Complaint. Ten similar complaints were filed in various federal district courts. In November 2003, the cases were transferred to the United States District Court for the Middle District of Pennsylvania and consolidated for pretrial purposes. Plaintiffs filed a consolidated complaint on February 16,

Table of Contents

Avery Dennison Corporation

2004, which the Company answered on March 31, 2004. On April 14, 2004, the court separated the proceedings as to class certification and merits discovery, and limited the initial phase of discovery to the issue of the appropriateness of class certification. On January 4, 2006, plaintiffs filed an amended complaint. On March 1, 2007, the court heard oral argument on the issue of the appropriateness of class certification. The Company intends to defend these matters vigorously.

On May 6, 2003, Sekuk Global Enterprises filed a purported stockholder class action in the United States District Court for the Central District of California against the Company and Messrs. Neal, O Bryant and Skovran (then CEO, CFO and Controller, respectively) seeking damages and other relief for alleged disclosure violations pertaining to alleged unlawful competitive practices. Subsequently, another similar action was filed in the same court. On September 24, 2003, the court appointed a lead plaintiff, approved lead and liaison counsel and ordered the two actions consolidated as the *In Re Avery Dennison Corporation Securities Litigation*. Pursuant to court order and the parties stipulation, plaintiff filed a consolidated complaint in mid-February 2004. The court approved a briefing schedule for defendants motion to dismiss the consolidated complaint, with a contemplated hearing date in June 2004. In January 2004, the parties stipulated to stay the consolidated action, including the proposed briefing schedule, pending the outcome of the government investigation of alleged anticompetitive conduct by the Company. On January 12, 2007, following the DOJ s closing of its investigation, the plaintiffs filed a notice of voluntary dismissal of the case without prejudice. On January 17, 2007, the Court entered an order dismissing the case.

On May 21, 2003, The Harman Press filed in the Superior Court for the County of Los Angeles, California, a purported class action on behalf of indirect purchasers of label stock against the Company, UPM and UPM s subsidiary Raflatac (Raflatac), seeking treble damages and other relief for alleged unlawful competitive practices, essentially repeating the underlying allegations of the DOJ Merger Complaint. Three similar complaints were filed in various California courts. In November 2003, on petition from the parties, the California Judicial Council ordered the cases be coordinated for pretrial purposes. The cases were assigned to a coordination trial judge in the Superior Court for the City and County of San Francisco on March 30, 2004. On January 21, 2005, American International Distribution Corporation filed a purported class action on behalf of indirect purchasers in the Superior Court for Chittenden County, Vermont. Similar actions were filed by Richard Wrobel, on February 16, 2005, in the District Court of Johnson County, Kansas; and by Chad and Terry Muzzey, on February 16, 2005 in the District Court of Scotts Bluff County, Nebraska. On February 17, 2005, Judy Benson filed a purported multi-state class action on behalf of indirect purchasers in the Circuit Court for Cocke County, Tennessee. The Company intends to defend these matters vigorously.

On May 25, 2004, officials from the European Commission (EC), assisted by officials from national competition authorities, launched unannounced inspections of and obtained documents from the Company s pressure-sensitive materials facilities in the Netherlands and Germany. The investigation apparently sought evidence of unlawful anticompetitive activities affecting the European paper and forestry products sector, including the label stock market. The Company cooperated with the now closed investigation.

On July 9, 2004, the Competition Law Division of the Department of Justice of Canada notified the Company that it was seeking information from the Company in connection with a label stock investigation. The Company cooperated with the now closed investigation.

On May 18, 2005, Ronald E. Dancer filed a purported class action in the United States District Court for the Central District of California against the Company, Mr. Neal, Karyn Rodriguez (VP and Treasurer) and James Bochinski (then VP, Compensation and Benefits), for alleged breaches of fiduciary duty under the Employee Retirement Income Security Act to the Company s Employee Savings Plan and Plan participants. The plaintiff alleges, among other things, that permitting investment in and retention of Company Common Stock under the Plan was imprudent because of alleged anticompetitive activities by the Company, and that failure to disclose such activities to the Plan and participants was unlawful. Plaintiff seeks an order compelling defendants to compensate the Plan for any losses and other relief. The court approved the parties stipulation to stay the matter pending the outcome of the government investigation of alleged anticompetitive conduct by the Company. The Company intends to defend this matter vigorously.

On August 18, 2005, the Australian Competition and Consumer Commission notified two of the Company's subsidiaries, Avery Dennison Material Pty Limited and Avery Dennison Australia Pty Ltd, that it was seeking information in connection with a label stock investigation. The Company is cooperating with the investigation.

On October 19, 2006, the DOJ notified the Company that the DOJ decided to close its criminal investigation into competitive practices in the label stock industry without further action.

On November 15, 2006, the Company announced that it had been notified that the EC had closed its investigation into the Company's competitive activities in the label stock industry with no action.

On June 18, 2007, the Canadian Department of Justice notified the Company that the Competition Law Division of the Canadian Department of Justice had decided to close its criminal investigation into competitive practices in the label stock industry without further action.

The Board of Directors created an ad hoc committee comprised of independent directors to oversee the foregoing matters.

Table of Contents

Avery Dennison Corporation

The Company is unable to predict the effect of these matters at this time, although the effect could be adverse and material.

In 2005, the Company contacted relevant authorities in the U.S. and reported the results of an internal investigation of potential violations of the U.S. Foreign Corrupt Practices Act. The transactions at issue were carried out by a small number of employees of the reflective business in China, and involved, among other things, impermissible payments or attempted impermissible payments. The payments or attempted payments and the contracts associated with them appear to have been relatively minor in amount and of limited duration. Corrective and disciplinary actions have been taken. Sales of the reflective business in China in 2005 were approximately \$7 million. Based on findings to date, no changes to the Company's previously filed financial statements were warranted as a result of these matters. However, the Company believes that fines or other penalties may be incurred. While the Company is unable to predict the financial or operating impact of any such fines or penalties, the Company believes that our behavior in detecting, investigating, responding to and voluntarily disclosing these matters to authorities should be viewed favorably. The Company and its subsidiaries are involved in various other lawsuits, claims and inquiries, most of which are routine to the nature of the business. Based upon current information, the Company believes that the resolution of these other matters will not materially affect us.

ITEM 1A. RISK FACTORS

Our ability to attain our goals and objectives is materially dependent on numerous factors and risks, including but not limited to, the following:

The demand for our products is impacted by economic conditions of the principal countries in which we operate. A decline in the economies in these countries could have an adverse effect on our sales and profitability.

We have operations in over 50 countries and our domestic and international operations are strongly influenced by matters beyond our control, including changes in the political, social, economic, tax and regulatory environments (including tariffs) in the countries in which we operate, as well as the impact of economic conditions on underlying demand for our products. In addition, approximately 60% of our sales are from international operations. Fluctuations in currencies can cause transaction, translation and other losses to us, which can negatively impact our sales and profitability.

We operate in some highly competitive markets. If we do not compete effectively, we could lose market share and experience falling prices, adversely affecting our financial results.

We are at risk that our competitors will expand in our key markets and implement new technologies making them more competitive. There is also the possibility that competitors will be able to offer additional products, services, lower prices, or other incentives that we cannot or will not offer or that will make our products less profitable. There can be no assurance that we will be able to compete successfully against current and future competitors.

We are also at risk with regards to changes in customer order patterns, such as changes in the levels of inventory maintained by customers and the timing of customer purchases, which may be affected by announced price changes, changes in the Company's incentive programs, or the customer's ability to achieve incentive goals. Changes in customers' preferences for our products can also affect the demand for our products.

We have acquired companies and our interest in various acquisition opportunities has increased. Acquisitions come with significant risks and uncertainties, including those related to integration, technology and personnel.

In order to grow our product lines and expand into new markets, we have made acquisitions and may do so in the future, including the acquisition of Paxar Corporation in June 2007. Various risks, uncertainties, and costs are associated with the acquisitions. Effective integration of systems, controls, objectives, personnel, product lines, markets, customers, suppliers, production facilities and cost savings can be difficult to achieve and the results are uncertain, particularly across our geographically dispersed organization. We may not be able to retain key personnel of an acquired company and we may not be able to successfully execute integration strategies or achieve projected performance targets set for the business segment into which an acquired company is integrated. Both prior to and after the closing of the transactions, our business and those of the acquired companies may suffer due to uncertainty or diversion of management attention.

There can be no assurance that acquisitions will be successful and contribute to our profitability and we may not be able to identify new acquisition opportunities in the future.

Table of Contents

Avery Dennison Corporation

Our increased level of indebtedness following the Paxar acquisition could limit our ability to incur additional debt to fund business needs over the medium term.

As a result of the Paxar acquisition in June 2007, our debt levels approximately doubled. Although significant debt reduction is anticipated over the medium term from both the cash flow generation of our underlying businesses and the synergies expected from the acquisition, circumstances both within and beyond our control could cause debt levels to remain elevated for a longer time frame than anticipated. These higher debt levels could negatively impact our ability to meet other business needs or opportunities and could result in higher financing costs.

Potential adverse developments in legal proceedings and an investigation regarding competitive activities and other legal, compliance and regulatory matters, including those involving product and trade compliance, Foreign Corrupt Practices Act issues and other matters, could impact us materially.

Our financial results could be materially adversely impacted by an unfavorable outcome to pending or future litigation and investigations, including an Australian Competition and Consumer Commission investigation into industry competitive practices, lawsuits pertaining to this investigation or to the subject matter of now concluded investigations by the U.S. Department of Justice, the European Commission, and the Competition Law Division of the Department of Justice of Canada (including purported class actions in the United States seeking treble damages for alleged unlawful competitive practices, and a purported class action related to alleged disclosure and fiduciary duty violations pertaining to alleged unlawful competitive practices, which were filed after the announcement of the U.S. Department of Justice investigation), the impact of potential violations of the U.S. Foreign Corrupt Practices Act based on issues in China, and other legal, compliance and regulatory matters, including product and trade compliance. See Item 1,

Legal Proceedings. There can be no assurance that any investigation or litigation outcome will be favorable.

Our future results may be affected if we generate less productivity improvement than projected.

We are undertaking efforts to reduce costs in many of our operations, including closure of facilities, headcount reductions, organizational simplification and restructuring, process standardization, and manufacturing relocation, and using a variety of tools such as Lean Sigma and Kaizen events, to increase productivity, which is not assured. Lower levels of productivity could reduce profitability. In addition, cost reduction actions could expose us to additional production risk and loss of sales.

As a manufacturer, our sales and profitability are also dependent upon the cost and availability of raw materials and energy, which are subject to price fluctuations, and the ability to control or pass on costs of raw materials and labor.

Inflationary and other increases in the costs of raw materials, labor and energy have occurred in the past and are expected to recur, and our performance depends in part on our ability to pass on these cost increases to customers in our selling prices for products, and to effect improvements in productivity. Also, it is important that we are able to obtain timely delivery of materials, equipment, and packaging from suppliers, and to make timely delivery to customers. A disruption to our supply chain could adversely affect our sales and profitability.

Slower growth in key markets could adversely affect our profitability.

Our business could be negatively impacted by a decline in key end use markets or applications for our products. Our overall performance will be influenced by these markets.

Our customers are widely diversified, but in certain portions of our business, industry concentration has increased the importance and decreased the number of significant customers.

In particular, sales of our office and consumer products in the United States are concentrated in a few major customers, principally office product superstores, mass market distributors and wholesalers. The business risk associated with this concentration, including increased credit risks for these and other customers, and the possibility of related bad debt write-offs, could negatively affect our margins and profits.

Our ability to develop and successfully market new products and applications is important in maintaining growth.

The timely introduction of new products and improvements in current products helps determine our success. Research and development for each of our operating segments is complex and uncertain and requires innovation and anticipation of market trends. We could focus on products that ultimately are not accepted by customers or we could suffer delays in production or launch of new products that could compromise our competitive position in such product markets.

Table of Contents

Avery Dennison Corporation

Infringing intellectual property rights of third parties or inadequately acquiring or protecting our intellectual property and patents could harm our ability to compete or grow.

Because our products involve complex technology and chemistry, we are from time to time involved in litigation involving patents and other intellectual property. Parties have filed, and in the future may file, claims against us alleging that we have infringed their intellectual property rights. If we are held liable for infringement, we could be required to pay damages or obtain licenses or to cease making or selling certain products. There can be no assurance that licenses will be available at all, or will be available on commercially reasonable terms, and the cost to defend these claims, whether or not meritorious, or to develop new technology could be significant and could divert the attention of management.

We also could have our intellectual property infringed. We attempt to protect and restrict access to our intellectual property and proprietary information, by relying on the patent, trademark, copyright and trade secret laws of the U.S. and other countries, as well as on nondisclosure agreements, but it may be possible for a third party to obtain our information without our authorization, to independently develop similar technologies, or to breach non-disclosure agreement entered into with us. In addition, many of the countries in which we operate do not have intellectual property laws that protect proprietary rights as fully as in the U.S. The use of our intellectual property by someone else without our authorization could reduce or eliminate certain competitive advantage we have, cause us to lose sales, or otherwise harm our business. Further, the costs involved to protect our intellectual property rights could adversely impact our profitability.

We have obtained and applied for some U.S. and foreign trademark registrations and patents, and will continue to evaluate whether to register additional trademarks and seek patents as appropriate. We cannot guarantee that any of the pending applications will be approved by the applicable government authorities. Further, we cannot assure that the validity of our patents or our trademarks will not be challenged. In addition, third parties might be able to develop competing products using technology that avoids our patents.

The amount of various taxes we pay is subject to ongoing compliance requirements and audits by federal, state and foreign tax authorities.

Our estimate of the potential outcome of uncertain tax issues is subject to our assessment of relevant risks, facts, and circumstances existing at that time. We use these assessments to determine the adequacy of our provision for income taxes and other tax-related accounts. Our future results may include favorable or unfavorable adjustments to our estimated tax liabilities in the period the assessments are made or resolved, which may impact our effective tax rate and/or our financial results. We are in the process of reviewing Paxar's compliance with such requirements.

We have deferred tax assets that we may not be able to use under certain circumstances.

If we are unable to generate sufficient future taxable income in certain jurisdictions, or if there is a significant change in the time period within which the underlying temporary differences become taxable or deductible, we could be required to increase our valuation allowances against our deferred tax assets. This would result in an increase in our effective tax rate, and an adverse effect on our future operating results. In addition, changes in statutory tax rates may also change our deferred tax assets or liability balances, with either favorable or unfavorable impact on our effective tax rate. Our deferred tax assets may also be impacted by new legislation or regulation.

The level of returns on pension and postretirement plan assets and the actuarial assumptions used for valuation purposes could affect our earnings in future periods. Changes in accounting standards and government regulations could also affect our pension and postretirement plan expense and funding requirements.

Assumptions used in determining projected benefit obligations and the fair value of plan assets for our pension plan and other postretirement benefit plans are evaluated by us in consultation with outside actuaries. In the event that we determine that changes are warranted in the assumptions used, such as the discount rate, expected long term rate of return, or health care costs, our future pension and projected postretirement benefit expenses could increase or decrease. Due to changing market conditions or changes in the participant population, the actuarial assumptions that we use may differ from actual results, which could have a significant impact on our pension and postretirement liability and related costs. Funding obligations are determined based on the value of assets and liabilities on a specific date as required under relevant government regulations for each plan. Future pension funding requirements, and the

timing of funding payments, could be affected by legislation enacted by the relevant governmental authorities.

Table of Contents

Avery Dennison Corporation

In order for us to remain competitive, it is important to recruit and retain highly-skilled employees. We also utilize various outsourcing arrangements for certain services.

There is significant competition to recruit and retain skilled employees. Due to rapid expansion in certain markets and the ongoing productivity efforts and recent employee reductions, it may be difficult for us to retain and recruit sufficient numbers of highly-skilled employees. We have outsourced certain services to multiple third-party service providers, and may outsource other services in the future to achieve cost savings and efficiencies. Service provider delays, resource availability, business issues or errors may lead to disruption in our businesses and/or increased costs. If we do not effectively develop, implement and manage outsourcing strategies, third-party providers do not perform effectively and timely, or we experience problems with a transition, we may experience disruption in our businesses, we may not be able to achieve the expected cost savings, and we may have to incur additional costs to correct errors made by such service providers.

We need to comply with many environmental, health, and safety laws.

Due to the nature of our business, we are subject to environmental, health, and safety laws and regulations, including those related to the disposal of hazardous waste from our manufacturing processes. Compliance with existing and future environmental, health and safety laws could subject us to future costs or liabilities; impact our production capabilities; constrict our ability to sell, expand or acquire facilities; and generally impact our financial performance. We have accrued liabilities for environmental clean-up sites, including sites for which governmental agencies have designated us as a potentially responsible party, where it is probable that a loss will be incurred and the cost or amount of loss can be reasonably estimated. We are in the process of reviewing the environmental matters related to Paxar. However, because of the uncertainties associated with environmental assessment and remediation activities, future expense to remediate currently identified sites and other sites, which could be identified in the future for cleanup, could be higher than the liability currently accrued.

In order to mitigate risk, it is important that we obtain various types of insurance.

We have various types of insurance including property, workers compensation and general liability. Insurance costs can be unpredictable and may adversely impact our financial results.

Significant disruption to our information technology infrastructure could adversely impact our operations, sales, customer relations, and financial results.

We rely on the efficient and uninterrupted operation of a large and complex information technology infrastructure to link our worldwide divisions. Like other information technology systems, ours is susceptible to damage or interruptions caused by obsolescence, natural disasters, power failures, viruses and security breaches. We upgrade and install new systems, which if installed or programmed incorrectly or if installation is delayed, could cause significant disruptions. We have implemented certain measures to reduce our risk related to system and network disruptions, but if a disruption occurs, we could incur losses and costs for remediation and interruption of operations. Additionally, we rely on services provided by third-party vendors for a significant portion of our information technology support, development and implementation.

Our share price may be volatile.

Our stock price is influenced by changes in the overall stock market and demand for equity securities in general. Other factors, including market expectations for our performance, the level of perceived growth of our industries, and announcements concerning industry investigations, have also impacted our share price. There can be no assurance that our stock price will be less volatile in the future.

If our credit ratings are downgraded, we may have difficulty obtaining acceptable short- and long-term financing from capital markets.

Credit ratings are a significant factor in our ability to raise short-term and long-term financing. The credit ratings assigned to us also impact the interest rates on our commercial paper and other borrowings. Standard and Poor's (S&P) has assigned us a credit rating of A-2 for short-term and BBB+ for long-term financing. S&P has our long term ratings on credit watch with negative implications pending the completion of the permanent financing of the Paxar acquisition. Moody's Investors Service (Moody's) has assigned us a credit rating of P2 for short-term and A3 for long-term financing. Moody's has our long term rating under review for possible downgrade as a result of the

additional debt incurred to fund the Paxar acquisition. If our credit ratings were further downgraded, our financial flexibility could decrease and the cost to borrow would increase.

Our reputation, sales, and earnings could be affected adversely if the quality of our products and services does not meet customer

Table of Contents

Avery Dennison Corporation

expectations.

There are occasions when we manufacture products with quality issues resulting from defective materials, manufacturing, packaging or design. Many of these issues are discovered before shipping but this causes delays in shipping, delays in the manufacturing process, and occasionally cancelled orders. When the issues are discovered after shipment, this causes additional shipping costs, possible discounts, possible refunds, and potential loss of future sales. Both pre-shipping and post-shipping quality issues can result in financial consequences along with a negative impact on our reputation.

Some of our products are sold by third parties.

Our products are not only sold by us, but by third party distributors and retailers as well. Some of our distributors also market products that compete with our products. Changes in the financial or business condition or purchasing decisions of these third parties could affect our sales and profitability.

We outsource some of our manufacturing. If there are significant changes in the quality control or financial or business condition of these outsourced manufacturers, our business could be negatively impacted.

We manufacture most of our products, but we also use third-party manufacturers, for example, for specialty jobs or capacity overflow. Outsourced manufacturers reduce our ability to prevent product quality issues, late deliveries, customer dissatisfaction and compliance with customer requirements for labor standards. Because of possible quality issues and customer dissatisfaction, outsourced manufacturers could have an adverse effect on our business and financial results.

The risks described above are not exclusive. Additional risks not presently known to us or that we currently consider to be less significant may also have an adverse effect on us. If any of the above risks actually occur, our business, results of operations, cash flows or financial condition could suffer, which might cause the value of our securities to decline.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) Not Applicable

(b) Not Applicable

(c) Purchases of Equity Securities by Issuer

The Board of Directors has authorized the repurchase of shares of the Company's outstanding common stock. Repurchased shares may be reissued under the Company's stock option and incentive plans or used for other corporate purposes. Repurchases of equity securities during the second quarter ended June 30, 2007 are listed in the following table.

		Total shares	Average price per share	Remaining authorization to repurchase shares
(Shares in thousands, except per share amounts)		repurchased⁽¹⁾		
April 1, 2007	April 28, 2007	138.9	\$ 63.26	4,154.7
April 29, 2007	May 26, 2007	80.6	62.89	4,154.7
Quarterly total		219.5	\$ 63.12	4,154.7

(1) Includes shares repurchased through

non-cash
activities that
were delivered
(actually or
constructively)
to the Company
by participants
exercising stock
options during
the second
quarter of 2007
under the
Company's stock
option and
incentive plans.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable

Table of Contents

Avery Dennison Corporation

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Information called for in this Item during the period is incorporated by reference to Part II, Item 4 in the Company's Form 10-Q filed on May 10, 2007.

ITEM 5. OTHER INFORMATION

Not Applicable

ITEM 6. EXHIBITS

Exhibit 10.2: Revolving Credit Agreement, dated June 13, 2007

Exhibit 12: Computation of Ratio of Earnings to Fixed Charges

Exhibit 31.1: D. A. Scarborough Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2: D. R. O Bryant Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1: D. A. Scarborough Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2: D. R. O Bryant Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

45

Table of Contents

Avery Dennison Corporation

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AVERY DENNISON CORPORATION
(Registrant)

/s/ Daniel R. O Bryant
Daniel R. O'Bryant
Executive Vice President, Finance, and
Chief Financial Officer
(Principal Financial Officer)

/s/ Mitchell R. Butier
Mitchell R. Butier
Vice President and Controller
(Chief Accounting Officer)

August 9, 2007

46